OAH Docket No. 69-2500-9783-2
MPUC Docket No. G-001/GR-95-406

STATE OF MINNESOTA
OFFICE OF ADMINISTRATIVE HEARINGS

FOR THE MINNESOTA PUBLIC UTILITIES COMMISSION

In the Matter of the Request of Interstate Power Company for Authority to Change Its Rates for Gas Service in Minnesota	**FINDINGS OF FACT, CONCLUSIONS, AND RECOMMENDATION**

The above-entitled matter came on for evidentiary hearing before Administrative Law Judge Steve M. Mihalchick on October 16 and 17, 1995, in St. Paul, Minnesota. The record was closed upon receipt of the final brief on December 12, 1995.

Appearances:

Kent M. Ragsdale and Christopher B. Clark, Staff Counsel, Interstate Power Company, P.O. Box 769, 1000 Main Street, Dubuque, Iowa 52004-0769, for Interstate Power Company ("Interstate," the "Company" or "IPW").

Dennis D. Ahlers, Brent Vanderlinden, and Ellen Gavin, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101, for intervenor Department of Public Service ("Department" or "DPS").

Sara J. DeSanto and Joan Peterson, Assistant Attorneys General, 1200 NCL Tower, 445 Minnesota Street, St. Paul, Minnesota 55101, for intervenor Office of the Attorney General ("OAG").

Karen Swett, ConAgra Energy Services Company, Nine ConAgra Drive, P.O. Box 3200, Dept. CIG 155, Omaha, NE 68103-0200, for intervenor ConAgra and its Freeborn Foods Division ("ConAgra").

Gerald Dasinger, Commission Staff, 350 Metro Square, 121 Seventh Place East, St. Paul, Minnesota 55101 for the Minnesota Public Utilities Commission ("Commission" or "MPUC").

NOTICE

Notice is hereby given that, pursuant to Minn. Stat. § 14.61, and the Rules of Practice of the Commission and the Office of Administrative Hearings, exceptions to this Report, if any, by any party adversely affected must be filed within 15 days of the mailing date hereof (unless the Commission directs a shorter period) with the Executive Secretary, Minnesota Public Utilities Commission, Metro Square Building, Suite 350, 121 7th Place East, St. Paul, Minnesota 55101. Exceptions must be specific and stated and numbered separately. Proposed Findings of Fact, Conclusions and Order should be included, and copies thereof shall be served upon all parties. If desired, a reply to exceptions may be filed and served within ten days after the service of the exceptions to which reply is made. Oral argument before a majority of the Commission will be permitted to all parties adversely affected by the Administrative Law Judge's recommendation who request such argument. Such request must accompany the filed exceptions, and an original and 13 copies of each document should be filed with the Commission.

The Commission will make the final determination of the matter after the expiration of the period for filing exceptions as set forth above, or after oral argument, if such is requested and had in the matter.

Further notice is hereby given that the Commission may, at its own discretion, accept or reject the Administrative Law Judge’s recommendation and that said recommendation has no legal effect unless expressly adopted by the Commission as its final order.

STATEMENT OF ISSUE

Should Interstate be allowed to increase its rate for gas utility service to Minnesota customers by $2,365,280 and collect revenues in accordance with its proposed rate design?

Based upon the record herein, the Administrative Law Judge makes the following:

FINDINGS OF FACT

PROCEDURAL HISTORY

1. On May 1, 1995, Interstate filed a petition pursuant to Minn. Stat. § 216B.16 (1994) with the Commission requesting authority to increase Interstate's rates for gas service in the State of Minnesota. The petition sought an increase in gas rates of $2,365,280 or 29.8 percent over existing rates.

2. On June 20, 1995, the Commission issued its Order Accepting Filing and Order Suspending Rates. In its Order Accepting Filing, the Commission ordered Interstate to file revised schedules on plant-in-service and cost allocations, as well as additional testimony on cost allocations and SFAS 106 benefit costs. Interstate filed those items on June 30, 1995.

3. On June 23, 1995, the Commission issued a Notice and Order for Hearing and an order setting interim rates at an increase of $1,502,316 or 19.7 percent above existing rates.

4. A prehearing conference was held on June 26, 1995, before Administrative Law Judge Richard C. Luis. The case was thereafter reassigned to Administrative Law Judge Steve M. Mihalchick (the “ALJ”) who issued a prehearing order on August 16, 1995.

5. Timely petitions to intervene were filed and granted for the OAG, the DPS and ConAgra.

6. Two public hearings were held to receive the testimony of the public and ratepayers in this matter. One hearing was held in Albert Lea on October 4, 1995 and the other hearing was held in Stewartville on October 5, 1995. Five individuals presented testimony at the Albert Lea. No testimony was presented at the Stewartville hearing.

7. Evidentiary hearings were held in St. Paul on October 16 and 17, 1995. The testimony of 20 witnesses was presented at the evidentiary hearings and 43 exhibits were admitted into evidence. The parties were permitted to file Stipulated Ex. 44 after the hearing. It was filed November 6, 1995.

8. Minn. Stat. § 216B.16, subd. 4, places the burden of demonstrating the reasonableness of a proposed rate increase on the utility. The Minnesota Supreme Court has held that in a rate proceeding before the Commission the burden is on the utility to prove the facts by a fair preponderance of the evidence. In Re Northern States Power Co., 416 N.W.2d 719, 722 (Minn. 1987). The utility bears the burden of not only proving that the costs were incurred but of proving the reasonableness of its position on these issues. As the Court stated it . . ."by merely showing that it has incurred, or may hypothetically incur, expenses, the utility does not necessarily meet its burden of demonstrating that it is just and reasonable that the ratepayers bear the costs of those expenses." Id. at 722, 723. If the evidence is insufficient to permit determination on a particular component of the proposed increase, the utility has failed to meet its burden of proof. Petition of Continental Telephone Co., 389 N.W.2d 910 (Minn. 1986).

CAPITAL STRUCTURE AND RATE OF RETURN

9. Interstate has selected January 1, 1994, to December 31, 1994, as the test year to be used for determining its revenue requirement. No party objected to the Company's test year. The Company's proposed test year is found to be reasonable.

10. As modified in rebuttal testimony, Interstate proposed the following capital structure; costs of short and long-term debt, preferred stock, and common equity; and returns on those elements:

Capital Structure - Year Ending 1994
(Ex. 16, Sched. 8)

	Amount	Percent	Cost	Return
Long-term debt	$206,175	43.972%	7.752%	3.409%
Short-term debt	35,600	7.593%	6.070%	0.461%
Preferred & Preference Stock	34,597	7.379%	7.225%	0.533%
Common Equity	192,505	41.057%	11.750%	4.824%
TOTAL	$468,877	100.000%		9.227%

11. Both DPS witness Dr. Luther Thompson and OAG witness Garth Morrisette recommended approval of Interstate's capital structure. Ex. 28, p. 22; Ex. 20, p. 7. Likewise, both the OAG and DPS accepted Interstate's proposed cost of long-term debt of 7.752%, short-term debt of 6.070%, and preferred stock of 7.225% as reasonable. Ex. 20, p. 7; Ex. 28, pp. 23-24. The OAG and DPS dispute Interstate's cost of common equity, also referred to as return on common equity ("ROE").

12. Interstate's proposed capital structure is reasonable and balances the competing interests of investors and consumers. Interstate's capital structure falls within the range of comparable companies in 1994. Ex. 28, p. 22. Interstate's proposed capital structure, cost of debt and cost of preferred stock should be adopted for this case.

13. Interstate presented the Testimony of Mr. Robert S. Jackson, a retired Senior Vice President of Stone & Webster Management Consultants, Inc., on the cost of common equity, capital structure, and overall return on rate base. Exs. 15 and 16. DPS presented the testimony of Dr. Thompson, Public Utilities Rate Analyst, on these issues. Exs. 28 and 29. OAG presented the testimony of Mr. Morrisette, Economist with the OAG. Ex. 20. Each

witness made a Discounted Cash Flow ("DCF") analysis applied to a group of companies they believed were of comparable risk to IPW, and a DCF analysis of IPW itself. In addition, Mr. Jackson prepared a comparable earnings analysis, a risk premium (CAPM) analysis, and a regression analysis of returns on equity allowed by state regulators in gas utility rate case proceedings and Moody's A-rated public utility bond yields to check the results of his DCF analysis.

14. In his Direct Testimony, Ex. 15, Mr. Jackson testified that the overall cost of capital at year-end December 31, 1994, was 9.432%, and the cost rate on common equity capital was 12.25%. He updated his study on September 22, 1995, to a common equity cost rate of 11.75%. This translates to an overall rate of return of 9.227% on rate base. Ex. 16, Schedule 8. Dr. Thompson recommended a return on equity of 10.8 percent and an overall rate of return of 8.837 percent. Ex. 28, p. 2. Mr. Morrisette recommended a return on common equity of 10.75 percent and an overall return of 8.82 percent. Ex. 20, p. 3.

15. The Commission is obligated to set rates that are just and reasonable. Minn. Stat. § 216B.03 (1994). The determination of reasonableness involves a balancing of consumer and utility interests; the Commission must insure that Interstate's authorized rate of return is set at a level which properly balances investor interests and consumer interests to the extent that Interstate will not earn excess profits. Ex. 28, pp. 4-7; Ex. 20, p. 6.

16. The United States Supreme Court has defined the proper regulatory balance between the interests of investors and ratepayers in the Bluefield and Hope cases. It held in Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), that a utility's return must be reasonably sufficient to assure financial soundness and provide the utility adequate means to raise capital. The Court concluded that a utility had no right to large profits similar to those realized in speculative ventures, but that the utility's return should be reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties. Bluefield, 262 U.S. at 693. In Federal Power Commission v. Hope Natural Gas Co., 320 U.S. 591 (1940), the Court reaffirmed and refined the Bluefield principles. The Hope Court reiterated the investor requirement for a return sufficient to cover operating expenses, including services on debt and dividends on stock and to assure confidence in the utility's ability to maintain credit and attract capital. The Court added that a just and reasonable return should be similar to returns on investments in other businesses having corresponding risk. Federal Power Commission v. Hope, 320 U.S. at 603. In addition, the Court has acknowledged that regulation must attempt to strike an equitable balance between investors and ratepayers. Covington and Lexington Turnpike Road Co. v. Sanford, 164 U.S. 578 (1896); In Federal Power Commission v. Natural Gas Pipeline Company of American, 315 U.S. 575, 62 S.Ct. 736 (1942).

17. Likewise, the Minnesota Supreme Court has recognized the requirement to establish a fair rate of return which will provide earnings to investors comparable to those realized in other businesses which are attended by similar risk, will allow the company to attract new capital as required, and will maintain the company's financial integrity. See, e.g, Northwestern Bell Telephone Company v. State, 299 Minn. 1, 5-6, 216 N.W.2d 841, 846 (1974).

18. A fair rate of return is one that is the best estimate of the required rate of return to the average investor. The required rate of return is that which is necessary to induce investors to buy or hold a security. An investor's rate of return should reflect the total evaluation of risks the investor is willing to assume for an expected return on investment. Ex. 28, pp. 8,

10. Because the required rate of return is that necessary to attract investors to buy or hold a security, it represents the utility's cost of capital. Ex. 28, p. 14. Thus, a fair rate of return for a utility should be no greater nor less than its weighted average cost of capital. Id. at 14.

19. Translating Interstate's risk into a just and reasonable return on equity requires an analysis which incorporates both its current yield and expected growth as well as an analysis of companies whose risk is comparable to that of Interstate. While no one method of analysis is necessarily required, the DCF method is generally considered to be the most basic and fair approach for regulatory purposes. It generally produces reasonable, consistent and fair estimates of the cost of common equity. DPS Exhs. 28, p. 15; and 29, p. 2; Ex. 20, p. 9. The Commission has consistently utilized the DCF method in making its determinations of the appropriate rates of return for Minnesota utilities. Findings of Fact, Conclusions of Law and Order, Interstate Power Co., Docket No. E001/GR-91-605 (1992), pp. 34-35. See also Interstate Power, MPUC Docket No. E001/GR-86-384 (1987), Findings of Fact, Conclusions of Law and Order p. 32; and Northern States Power Co., MPUC Docket No. E002/GR-91-1 (1991) Findings of Fact, Conclusions of Law and Order p. 68.

Company's Position: DCF Method

20. The theoretical foundation of the DCF method is that the value of an asset is determined by its ability to generate future earnings and cash flows to the owner of the asset. The return on equity expected by shareholders (their required return) equals the expected dividend yield (annualized dividend divided by market price per share), plus the expected annual growth in dividends from future earnings. The DCF method also assumes that dividends, earnings and book value all grow at the same rate for an indefinite period. Ex. 15, p. 13, Ex. 28, p. 16, Ex. 20, p. 9.

21. Mr. Jackson testified to some inherent weaknesses of the DCF model. He noted that the foundation of the DCF model rests largely upon the efficient market hypothesis that assumes that the current market price is the best available estimate of a stock's true value. Ex. 15, p. 14. In Mr. Jackson's view, it is not unreasonable to conclude that market price changes may be attributable to psychological factors including investor overreaction to earnings, dividends, or other news; to waves of social optimism or pessimism; to fashions or fads; or to the "herd" instinct. In his opinion, to the extent that market prices do not reflect true “value” at all times, the exclusive use of DCF as a determinant of the current cost of equity in a rate proceeding is called into serious question. Ex. 15, p. 15.

22. In his attempt to establish the current cost of equity capital for IPW, Mr. Jackson made capitalization ratio, earned equity return, and market/book ratio studies of a group of comparison gas distribution companies contained in the Value Line Investment Survey (Value Line). Ex. 15, p. 5. After determining his comparison group, Mr. Jackson made a comparable earnings analysis, a DCF analysis, as well as a dividend payout ratio study of each member of the group and IPW. Id. Mr. Jackson also prepared a risk premium (CAPM) analysis as well as a regression analysis of returns on equity allowed by state regulators in gas utility rate case proceedings and Moody's A-rated public utility bond yields. Ex. 15, pp. 6-7.

23. Mr. Jackson determined that earned returns on equity have been generally lower than authorized returns throughout the 1990-1994 period for the comparison group. The average earned return for the group for that period was 10.6 percent. Value Line estimates the 1998-2000 average return for the group at 12.3 percent. IPW earned an average return on

common equity of 10.7 percent during the last five years and the Value Line estimate for the 1997-1999 period projects a return of 11.0 percent on IPW's common equity. Ex. 15, p. 11.

24. It was Mr. Jackson's opinion that the average market/book ratios for the companies comprising the group for each year 1990-1994 have ranged from a low of 1.41 to a high of 1.85 during this period, averaging 1.60 for the five-year period. Further, he noted that Value Line estimates an average market/book ratio of 1.50 for the group during the 1998-2000 period. IPW's average market/book ratio during the 1990-1994 period was 1.41. The ratio ranged during this period from a low of 1.26 to a high of 1.55. The 1997-1999 Value Line appraisal of market/book ratio for IPW is 1.34. Ex. 15, pp. 11-12.

25. The results of Mr. Jackson's DCF study are summarized on Schedule 3 of Ex. 15. Page 1 of the schedule shows the average of the high and low monthly market prices during the period December 1994 to February 1995 for each of the comparison companies and IPW. Page 2 contains several growth rate tests for each member of Mr. Jackson's comparable group. Mr. Jackson analyzed historic and estimated future growth rates in per-share dividends and estimated future growth rates in per-share earnings for each company of his comparable group. The growth rate used in Mr. Jackson's DCF study is the average of four growth rates. In Mr. Jackson's view, his estimate of growth for the three month period is consistent with the traditional long-term period recognized in the DCF formula and reflects the quarterly dividend payment patterns common to the comparison group and Ex. 15, pp. 17.

26. Dr. Thompson argued that by using quarterly data, Mr. Jackson’s DCF analysis incorrectly assumes ratepayers are responsible for paying a return on the quarterly dividends paid to investors. Ex. 28, p. 35. Mr. Jackson responded that this misstated the quarterly DCF model because investors returns are paid by the company in which the investment is made and that the quarterly DCF model sets forth the indicated cost of capital required by investors, but makes no assumption beyond that. Ex. 16, p. 3

27. Mr. Jackson's DCF study, labeled "DCFQM" in Ex. 15, Schedule 3, page 3, shows cost rates for the comparison group of companies ranging from a low of 9.68 percent to a high of 12.13 percent and averaging 11.06 percent for the group and 10.87 percent for IPW.

28. Mr. Jackson argued that these cost rates do <u>not</u> represent the fair rate of return to be applied to IPW's book value in this case because the average relationship of market price and book value for the comparison group and for IPW during the last five years has averaged about 150 percent. Mr. Jackson noted that with such a large disparity between current market prices and underlying book values, the indicated return on book is significantly higher than that on market prices. For example, the average "DCFQB" return for the comparison group is shown at 16.44 percent in sharp contrast with the "market" return of 11.06 percent. For IPW the "book" return of 12.69 percent may be compared with the "market" return of 10.87 percent. Ex. 15, p. 21.

29. According to Dr. Thompson, Mr. Jackson's DCF analysis is also inappropriate for regulatory purposes because his adjustment of the DCF result to account for a market-to-book ratio greater than one is inappropriate. Ex. 28, p. 35. Mr. Jackson maintains that if regulators set the allowed ROE based on the DCF method, the stock price will be driven down until the market-to-book ratio equals 1.0, because the DCF method assumes a market-to-book ratio of 1.0. However, the stock price is set by the market <u>not</u> by regulators. Such an approach is at odds with basic economic theory because it assumes that shareholders

who invest in utilities with market-to-book ratios in excess of 1.0 do so with the knowledge that the price will be driven down to book value. Ex. 20, p. 19.

30. Mr. Jackson's DCFQB method is flawed because it ignores the actual market for the stock of the comparison companies. The yield portion of the DCF method is calculated to be D/P where D is the current dividend P is the <u>market</u> price. Ex. 15, p.14. If D/P is multiplied by the market-to-book ratio, or P/B, as Mr. Jackson recommends, the result is simply D/B. Thus, the market price completely falls out of the equation and is ignored. Since the market price represents what investors are willing to pay in the market for a particular company's stock, it is unreasonable for this company-specific market information to be ignored in this fashion. Moreover, this elimination of market forces from the ROE analysis is contrary to the goals of rate of return analysis. As discussed above, the goal of ROE analysis is to determine what <u>investors</u> require in the marketplace. Therefore, actual market information is of paramount importance.

31. The Commission has already rejected the DCFQB methodology proposed by Mr. Jackson because, “By eliminating the market factor from its DCF-2 [DCFQB] analysis, Mr. Jackson produces a book yield and ROE which is not market-based and does not reflect current market conditions.” <u>Interstate Power Company</u>, Docket No. E-001/GR-91-605, Findings of Fact, Conclusions of Law, and Order, p.36, n.16 (June 12, 1992) (parenthetical added).

32. Mr. Jackson's method produced unrealistic results. His DCF approach produces ROE estimates ranging from 13.73% to 19.45% with an average ROE for his group companies of 16.43%. As Mr. Morrisette testified, that estimate is well outside the realm of reasonableness, does not represent sustainable long-term growth and is well beyond the most optimistic industry analyst projections. Ex. 20, p. 20.

<u>Company’s Position: Other Methods</u>

33. Mr. Jackson also estimated a cost-of-equity return by relying upon a risk premium analysis based on the capital asset pricing model, or CAPM. The theoretical underpinning of the risk premium analysis is the existence of an alleged linkage between the return on stocks and bonds. Ex. 15, p. 25.

34. Mr. Jackson calculated his risk premium recommendation by using the market data for a group of comparable utilities. Originally, Mr. Jackson calculated an ROE of 11.78 percent using the risk premium approach. In his rebuttal testimony, Mr. Jackson updated his analysis to reflect the most recent 30-year Treasury Bond rates. The updated calculation resulted in estimated ROE of 10.78 percent, a full percentage point below his original estimate. Ex. 16, Appendix E.

35. In past rate cases, the Commission has consistently rejected the use of the risk premium method for establishing rate of return on equity. <u>See</u> <u>United Telephone Company</u>, Docket No. P-430/GR-84-597; <u>Northwestern Bell Telephone Company</u>, Docket No. P-421/GR-83-600; <u>Central Telephone Company</u>, Docket No. P-405/GR-83-300; <u>Continental Telephone Company</u>, Docket No. P-407/GR-83-294. The Commission has stated: "The Commission has consistently rejected risk premium methods because of the volatility of results." <u>Northern States Power Company</u>, Docket Nos. G-002/GR-86-160, G-002/M-86-165, Findings of Fact, Conclusions of Law, and Order, p.50 (Jan. 27, 1987).

36. Mr. Jackson also included a payout ratio test in his analysis. He noted that the payout ratio for a company represents the proportion of its earnings that are paid out in the form of dividends to shareholders. Ex. 15, p. 22. He noted that the current average payout ratio for the comparison companies in his study for the 1990-1994 period is 81 percent. Ex. 15, p. 23. Mr. Jackson's average excludes those years during which the payout ratio exceeded 100 percent. Ex. 15, p. 22. Mr. Jackson noted that Value Line reports that the average percentage of all dividends to net profit for the natural gas distribution industry during the 1991-1995 period was 78 percent and that Value Line estimates the 1996 payout ratio at 72 percent and 64 percent for the 1998-2000 period for that industry. Ex. 15, p. 23. Mr. Jackson compared these results with IPW's payout for the 1990-1994 period. He noted that IPW's payout ratio exceeded 100 percent in each of the last three years (1992-1994) and that the adjusted average payout for the five-year period 1990-1994 is 75.0 percent (the average for 1990-1991). Id. He found that this ratio was in line with the natural gas distribution industry average during the same period and as forecast for 1996. Id.

37. The average return on equity for Mr. Jackson's comparison group is 11.37 percent. Based on its average payout ratio of 75.0 percent, the indicated return on equity for IPW is 13.67 percent.

38. The payout ratio study used by Mr. Jackson is unreliable. His study assumes that the 1990-1994 mean historical payout ratios, excluding payout ratios greater than 1.00, represent the expected payout ratios for the group. This assumption has not been shown to be correct. Since all payout ratios greater than 1.00 were excluded, the historical rates were not based on actual numbers and therefore may not represent a current market rate of return. Ex. 28, p. 36; Ex. 29, p. 3.

39. Mr. Jackson also attempted to estimate Interstate's required ROE using a simple linear regression model. Using this regression analysis, Mr. Jackson calculated the historical relationship between the allowed ROE in all gas distribution rate cases between 1982 and 1994 and A-rated public utility bond yield over the same time period. He found an indicated current cost of common equity of 12.00 percent. Ex. 15, pp. 27-28.

40. Mr. Jackson's regression model is overly simplistic and results in biased estimates. Mr. Jackson's results are biased because his regression model is incomplete. Ex. 20, p.23. That is, he fails to take into account the effect of other important variables that might affect the allowed ROE awarded by state commissions, including: measures for the utility's actual requests; embedded cost of debt; whether the utility is a wholly owned subsidiary; whether the firm presents testimony in support of its request; whether there are intervenors opposing the firm's request; whether it is a natural gas or electricity proceeding; and whether or not the firm is efficient. If regression models omit important explanatory variables, the results of the regression analysis will be biased and inconclusive. Because Mr. Jackson's model does not factor in such variables, it cannot be expected to produce reliable ROE estimates. Ex. 20, p.23.

41. Mr. Jackson updated his study, a copy of which is attached to Ex. 16. This new study produced a current cost of equity range between 11.45 percent and 11.88 percent. Ex. 16, p. 2. Mr. Jackson recommended a cost rate toward the upper end of that range, or 11.75 percent, for IPW. Id. This recommendation compares with the original filing supporting an equity cost rate of 12.25 percent for the IPW's Minnesota gas operations. As shown on Schedule 8 attached to Ex. 16, Mr. Jackson's recommended overall cost of capital using an equity cost rate of 11.75 percent, is 9.227 percent. Mr. Jackson stated that an earned return at

this level by IPW would support its overall operations thereby balancing the often competing concerns of ratepayers and shareholders.

DPS Position: DCF Method

42. To estimate the current dividend yield, Dr. Thompson used the most recent quarterly data available from Compustat's financial base. For his 20-day yield, Dr. Thompson used the most recent price data available from the Dow Jones data base as of July 17, 1995. Ex. 28, p. 25. An average of the two-year annual yield (8.296%), the one-year annual yield (8.886%), the most recent quarterly data (8.620%), and the 20-day yield (8.738%). Ex. 28, p. 25, Table 3. DPS witness Thompson's resulting average was 8.635%. Id. at 25. Based upon a review of the different yields as well as trends in the dividend yield, Dr. Thompson used a range of 8.65% to 8.75% as a reasonable estimate of the current dividend yield for the current regulatory period. Id. at 25. Dr. Thompson argued that this estimated range captures the current dividend yield for the expected regulatory period. He chose 8.70% as the current dividend yield. Id. at 25.

43. Dr. Thompson used an average of five-year and ten-year growth rates along with forecasted rates to determine a reasonable estimate of the growth rate in dividends per share, asserting that the growth component of the DCF formula is the rate at which current investors expect dividends to grow indefinitely, or at least through their investment time horizon. Dr. Thompson placed more emphasis on growth rates in book value and dividends. Ex. 28, pp. 19-20.

44. Dr. Thompson testified that, generally, growth in book value per share tends to be the most reasonable estimate of expected growth in dividends for an indefinite future period. Growth in book value per share is preferable to the growth rate in dividends per share and earnings per share because when earnings increase or decrease management usually prefers to adjust the dividend payout ratio to minimize the impact of earnings fluctuations on dividends. Consequently, growth in dividends per share may not be the best measure of a long-term growth rate due to management manipulation of the dividend growth rate through its changing dividend policies. Ex. 28, p. 20.

45. Dr. Thompson examined Interstate's five- and ten-year growth rates in book value, dividends, and earnings per share, as well as log linear growth rates. Ex. 28, p. 27, Table 4. He determined that a fair and reasonable estimate for the expected growth rate for Interstate is in the range of 2 percent. Id. at 29. In addition to Interstate's historical trends, he based this estimate on estimates and analysts' projections of future growth by Value Line and Zacks that indicate that growth in earnings will be lower. Id.

46. Dr. Thompson also looked at the internal growth rate and determined that the five and ten-year internal growth rates are 3.408 percent and 2.186 percent, respectively, when negative interest growth rates are excluded. Id., p. 27; Ex. 28, LCT-3, pp. 44.

47. Dr. Thompson reviewed Interstate's dividend-payout ratio and earnings on common equity for the past ten years for trends. He also looked at growth rates for book value, dividends per share and earnings per share and calculated the coefficients of variation. Ex. 28, p. 28, Table 5.

48. Dr. Thompson concluded that 2 percent appeared to be an appropriate growth estimate, based on the investors' reasonable expectations for long-term growth based on

historical growth rate and analysts' forecasted growth rates. Id. Based on a current dividend yield of 8.70% and a 2% growth rate, Dr. Thompson estimated a cost of common equity for Interstate of 10.7%. Ex. 28, p. 29.

49. To confirm the reasonableness of his rate of return estimate, Dr. Thompson performed a DCF analysis on a comparable group of gas distribution utilities. Ex. 28, p. 29-30. He used several criteria to establish risk comparability: industry classification, total risk and systematic risk. Ex. 28, p. 30. Using the most recent data available, Dr. Thompson determined the range of the comparable groups' dividend yields as 5.45 percent to 5.65 percent. He chose 5.55 percent, the midpoint, as a reasonable estimate of the current dividend yield. Ex. 28, pp. 30-31; Tr. 172. He then determined a growth rate of 5.25 percent for the comparable group by examining the growth in book value per share, dividends per share and earnings per share for five and ten year periods. Ex. 28, p. 31; Table 7. Using 5.55 percent for the current dividend yield and 5.25 percent expected growth rate, he determined a cost of equity of 10.8 percent for the gas distribution group. Ex. 28, p. 32.

50. Dr. Thompson recommended 10.80 percent for this case rather than the 10.70 percent cost of equity that he determined for the combined gas and electric operation of Interstate Power since the return for the comparable group of gas companies is the best estimate for Interstate's gas operations. He determined that a reasonable cost of equity for the comparable group was 10.8% (midpoint of a range between 10.7% and 10.9%). Id. at 32.

51. In Dr. Thompson’s opinion, because Interstate's gas operation is more risk comparable to other gas distribution companies than to the combined Interstate Power, the market required rate of return for the comparable group of gas utilities is the best estimate for Interstate Gas's cost of common equity.

52. Based upon the information contained in his DCF analyses, his comparable groups and taking into consideration the outlook for the financial markets and general economy in the near future, Dr. Thompson confirmed that 10.8% is the reasonable upper limit for Interstate's current cost of common equity. Ex. 28, p. 33. Based on this conclusion, he recommended an overall rate of return for Interstate Gas of 8.837%. Id. at 34.

OAG Position: DCF Method

53. In order to construct a group of comparable companies, OAG witness Morrisette began with 26 local distribution companies (LDCs) followed by Value Line, a widely published and cited investment report. These companies are also listed in Standard and Poor's monthly Stock Guide and have common stock that is actively traded. Ex. 20, p.8. Thus, there were sufficient, readily available, and recent data about these companies with which to conduct a DCF analysis.

54. Mr. Morrisette screened this group of 26 companies by limiting the comparable group to companies which: (1) derived at least 90% of their operating revenues from utility operations and (2) had an operating history of ten years or more. Mr. Morrisette eliminated companies with non-utility operations accounting for more than 10% of total revenues to derive a comparable group of primarily gas-based utility companies. By using such a group, Mr. Morrisette was able to focus his study on investor expectations of the risk associated with the type of utility operation at issue in this case. This first screening factor eliminated 9 companies with more diverse operations. Ex. 20, p.8.

55. The second screening criterion used by Mr. Morrisette ensured that the comparable group would consist of established companies, like Interstate, and would provide sufficient, reliable data covering the most recent ten-year period. This secondary screen eliminated one company with an operating history of less than ten years. The resulting comparable group included a total of 16 companies. This group is geographically diverse and consists only of reasonably financially healthy companies rated "3" (average) or above by Value Line in terms of "safety" or risk. Ex. 20, p.8, Schedule 2 and Appendix A.

56. The criteria used by Mr. Morrisette produced a comparable group which provides a reasonable proxy for Interstate's gas operations only. Taken as a whole, Mr. Morrisette's comparable group closely matches Interstate's investment risk and provides a sound basis for estimating the Company's required return on equity. Use of a comparable group as a proxy for Interstate's Minnesota gas jurisdiction is appropriate because the market data necessary to perform a DCF analysis for Interstate's Minnesota gas operations alone are not available.

57. OAG witness Morrisette calculated the dividend yield component of the DCF analysis by dividing the annualized dividend rate by the stock price and estimated the average stock price of the comparable companies by using the average stock price (average of monthly high and low) for each company for the six-month period ending in July 1995 as reported in Standard & Poor's Stock Guide. Ex. 20, p.10-11. Based upon dividend data from the same service, Mr. Morrisette calculated the annualized dividend and divided it by the average stock price for each of the six months. These calculations resulted in a finding of the current dividend yield of 6.10 percent for the most recent six months. Ex. 20, p.11, Schedule 2.

58. The use of data for a recent six-month period recognizes current data, while avoiding the volatility associated with using a "spot" yield which looks at data from a very short time frame. In this sense, the use of six month data represents a fair compromise between the need to recognize current data and the need for stability in the ratemaking process. Ex. 20, p.10.

59. As a check for reasonableness, OAG witness Morrisette also calculated the average dividend yield for the most recent three months and twelve-month periods. Both calculations yielded an average of 6.08 percent, indicating that the dividend yield has been relatively constant over the past year and that using the most recent six months provides a reasonable estimate. Ex. 20, p.12.

60. Finally, upon determining the current dividend yield, Mr. Morrisette adjusted the dividend yield estimate upwards by one-half-year's growth in dividends so that the final dividend yield will be based upon the dividend an investor expects to receive during the first year after purchase. Ex. 20, p.10. Assuming the yearly growth to be 4.5 percent (or 2.25 percent for a half-year), Mr. Morrisette calculated an adjusted yield of 6.25 percent (6.10% x 1.0225) for his proxy group of companies. Ex. 20, p.11.

61. The second component of the DCF analysis determines the growth portion of an investor's expected return. Mr. Morrisette testified that the most common methods for estimating the growth component of the DCF method are: (1) growth in retained earnings; (2) analysts' growth estimates; and (3) extrapolations from past trends in earnings per share, dividends per share and book value per share. Ex. 20, pp. 10-12. Although Mr. Morrisette relied most heavily on the retained earnings method, he also evaluated the results from the other

methods. For IPW comparable companies, Mr. Morrisette's analysis produced a growth rate of 4.25 percent.

62. The earnings retention method is consistent with the theoretical basis of the DCF method because it produces a constant growth rate as well as identical growth rates in earnings, dividends and book value. The earnings retention method produces a growth rate comprised of two components -- internal growth and external growth. Ex. 20, p.12. Under the earnings retention method, Mr. Morrisette calculated the internal growth rate by multiplying the return on common equity estimated to be earned in the future by the percentage of earnings presumed to be retained and reinvested by the company (retention rate). Ex. 20, pp. 12-13.

63. OAG witness Morrisette developed his estimates of the future earnings and the future retention rate for Interstate by examining historical data for the sixteen comparable companies, taking into consideration recent and current developments. With respect to historical data, he compiled the return on book common equity and the retention rate for each year from 1985-1994 for each company. With these data, he calculated five-year (1990-1994) and ten-year (1985-1994) averages for estimated earnings and retention rate. Ex. 20, p.13.

64. This analysis produced an average return of 11.15 percent for the last five years and 11.95 percent for the last ten years, with a combined average of 11.55 percent. The retention rate for these two intervals was 17.73 percent and 21.72 percent, respectively, with a combined average of 19.72 percent. Analysis of these historical results produced an internal growth rate of 2.28 percent. Ex. 20, p.13.

65. In developing his final internal growth rate, Mr. Morrisette, using Value Line projections, calculated an average earned return on book equity of 12.0 percent and an average retention rate of 28 percent for his group of comparable companies, implying an internal growth rate of 3.50 percent. OAH Ex. 20, p.14.

66. Mr. Morrisette testified that in addition to internal growth, growth from retained earnings is comprised of external growth as well. While internal growth results from retained earnings, external growth results from the issuance of stock. For example, the issuance of stock at a price in excess of book value tends to enhance growth. Since the gas utility companies in the comparable group have been selling at prices above book value, this factor is expected to provide some contribution to long-term growth. Ex. 20, p.14.

67. To quantify this growth, Mr. Morrisette performed an analysis of the sixteen comparable companies, examining the companies' current market-to-book ratios and Value Line projections of new common equity issuances through 1999. Ex. 20, p. 15 and Schedule 5. Based on this analysis, Mr. Morrisette adopted a range of 0.50 percent to 1.00 percent. Mr. Morrisette adopted a range to account for the inherent uncertainty as to future stock issuances. He then used the midpoint of the range to estimate an external growth factor of .75 percent. When added to the internal growth rate of 3.50 percent, this produced a total growth for Interstate of 4.25 percent. Ex. 20, p.15.

68. In developing his final recommended growth rate for Interstate, Mr. Morrisette considered historical growth in earnings, dividend, and book values over the past five years and ten years as a supplement to his retained earnings analysis. The historical growth in earnings was 3.30 percent over the last five years and 3.33 percent over the last ten years. The growth in dividends over the past five and ten years was 2.49 percent and 3.60 percent, respectively. Ex. 20, p. 12. These figures tend to confirm the reasonableness of Mr. Morrisette's analysis,

while suggesting that the growth rate may even be conservatively high. Investment analyst projections by Value Line and Institutional Brokers Estimations System ("IBES") also confirm the reasonableness of the 4.25 percent earnings retention method growth result. They also suggest that Mr. Morrisette's 4.25 percent growth rate may be conservatively high. Long-term Value Line and IBES projections average 4.70 percent. OAH Ex. 20, p. 15-16.

69. Mr. Morrisette found the appropriate growth range to be between his earnings retention result of 4.25 percent and the combined IBES and Value Line averages of 4.70 percent. Ex. 20, p. 17. He recommended that the mid-point of this range, or 4.50 percent, is the appropriate estimated growth rate for the purpose of deriving the estimated ROE. This number may be conservatively high.

70. Combining his dividend yield of 6.25 percent with his growth rate of 4.50 percent, Mr. Morrisette recommended an ROE of 10.75 percent. Ex. 20, p. 17.

MUI Proposal: Average of Recent Decisions

71. At the conclusion of the hearing, the Administrative Law Judge (Tr. 286) asked the parties to comment on information provided by Mr. Lester Ericsson on behalf of the Minnesota Utility Investors ("MUI") at the Albert Lea public hearing. Albert Lea Tr. 14-19; Public Hearing Ex. 5. The information provided by Mr. Ericsson supported a return on common equity of 11.99 percent and was based upon an average of recent decisions around the country. The result was very consistent with Mr. Jackson's regression analysis of returns on equity allowed by state regulators in gas utility rate case proceedings and Moody's A-rated public utility bond yields which indicated a cost of equity of 12.00 percent. Ex. 15, pp. 27-28.

72. The DPS and the OAG oppose consideration of the MUI's proposal. The DPS and the OAG took the position that this type of proposal, raised at a public hearing, should not be considered as substantive evidence in this proceeding. They argued that rate of return testimony is traditionally and properly presented through expert witnesses who are qualified to analyze complex financial issues related to utility regulation, such as rate of return. The DPS and the OAG argued that such experts study the specific facts of the cases before them and apply sophisticated analytical tools, such as the DCF model, to determine the rate of return for a particular company. In addition, they pointed out that expert witnesses prefile their testimony and are subject to cross-examination so their methods and reasoning can be tested by opposing parties.

73. MUI's proposed ROE is not based on a method of calculating ROE that has been shown to be analytically sound or has been accepted by the Commission. It was considered in this report to provide some support for Mr. Jackson's regression analysis, which has also been found to be overly simplistic.

Discussion

MUI's proposed ROE was presented at a public hearing by a MUI member who did not disclose any particular education or experience which would entitle his testimony to be treated as expert testimony. In fact, it appeared that he was simply reading a document prepared by someone else. MUI did not intervene as a party, and thus the testimony was not prefiled.

OAG and DPS argued that the failure to prefile, the practical inability to cross examine, and the lack of exert qualifications should result in an outright rejection of Ericsson's testimony.

The ALJ has not rejected the testimony for those reasons. Each of those reasons affects the weight to be given the testimony, but does not require that it be rejected outright.

Members of the public should be encouraged to offer testimony on the relevant issues, including rate of return. Even if the testimony is based on a novel methodology that has not been used by experts or adopted by the Commission, the testimony should nonetheless be considered and weighed using traditional factors such as past precedent, witness qualifications, ability to withstand scrutiny, etc. The failure to prefill and the practical inability to be cross examined are factors that must carry substantial force in the weighing process. But even they do not require that the testimony be ignored. In this case, the ALJ did consider the testimony from Mr. Ericsson and weighed it using the traditional factors.

<u>ALJ Position: DCF Method</u>

74. It is found that the appropriate method for calculating a fair ROE is the DCF method. It produces consistent, reliable results and has been consistently used by the Commission.

75. The ALJ adopts the analysis of Mr. Morrisette and his 6.25 percent dividend yield and 4.50 percent estimated growth rate for the purpose of deriving the estimated ROE. Combining the 6.25 percent dividend yield with a growth factor of 4.50 percent produces an ROE of 10.75 percent, which is an appropriate ROE that fairly balances the requirements of shareholders and the interests of ratepayers.

<u>Discussion</u>

Mr. Jackson argues that because the traditional DCF methodology assumes a market-to-book ratio of 1.0 it leads to a noncompensatory market rate of return whenever the M/B is greater than one. Ex. 15, pp. 19-20. This assumption of a M/B of 1.0, however, is appropriate because in the long run M/B ratios do tend toward 1.0. Ex. 20, p.20. Thus, the DCF model is not based on a flawed assumption.

Mr. Jackson states that FERC Order 636 has heightened the perception of investment risk in gas distribution utilities. This statement is based on outdated information and does not recognize recent developments that refute this conclusion, including the pass-through of FERC 636 transition costs to ratepayers through purchased gas adjustments. Ex. 20, p.24. Thus, FERC Order 636 is not an appropriate factor to consider in setting the return on equity.

For all the foregoing reasons, Mr. Jackson's rate of return analysis is rejected. Mr. Jackson relies heavily on non-DCF methodologies in estimating his proposed rate of return on common equity. As discussed above, the alternative methodologies put forth by Mr. Jackson, particularly the DCFQB payout ratio, CAPM, and regression analysis, are flawed and cannot be relied on to produce a fair and reasonable ROE. Mr. Jackson has failed to rebut the weaknesses in these methods pointed out by OAG witness Morrisette and DPS witness Thompson. The ALJ finds no flaws in either Mr. Morrisette's or Dr. Thompson's analyses and that they are mutually corroborative. (Dr. Thompson determined a 10.7 percent ROE for Interstate and a 10.8 percent ROE for his comparison group.) The ALJ, therefore, adopts Mr. Morrisette's rate of return of 10.75 percent.

76. The appropriate rate of return and capital structure for Interstate is summarized in the following table:

	Capital Structure	Cost Of Capital	Weighted Average
Short Term Debt	7.593%	6.070%	0.461%
Long Term Debt	43.972%	7.752%	3.409%
Preferred Stock	7.379%	7.225%	0.533%
Common Equity	41.057%	10.75%	4.414%
	100.000%		8.817%

77. An upper limit of 10.75% permits Interstate to attract capital and maintain financial integrity and is consistent with investor expectations. Thus, it balances the interests of consumers and investors.

78. The appropriate required overall rate of return for Interstate is 8.817 percent based upon a return on equity of 10.75 percent, as well as the Company's proposed costs of long and short-term debt and preferred stock and capital structure. This will enable Interstate to maintain its financial integrity while resulting in just and reasonable rates for ratepayers and should be adopted for this case.

RATE BASE

Rate Case Expenses

79. Interstate proposed a three-year amortization of its estimated rate case expenses of $160,958. The Company proposed to include one-third of its total estimated rate case expense ($53,653) in test year expense and add $134,132 to rate base as an unamortized balance of rate case expenses on which it would earn a return. Ex. 13, Schedule C-4, p. 18.

80. The Department and OAG, while not disputing the total estimated expense of $160,958, did dispute how it should be recovered. The OAG believes that the appropriate period for amortization of these expenses is five years. This recommendation is based on the frequency with which Interstate has historically filed gas rate cases. Since 1975, Interstate has consistently filed gas rate cases every five years. Ex. 21, p.13. DPS witness Bender proposed that an average annual amount of rate case expense be included as a test year operating expense, with no adjustment to rate base.

81. The Company argues that an unamortized balance needs to be included in rate base is to recognize the time value of money. Ex. 14, p. 6. IPW witness Lassance testified that this amortization of rate case expense results in the rate that customers pay reflecting the average cost of doing business in the provision of utility service. (Id.) IPW can only increase its rates to cover increased costs through the rate case process because it is a regulated business. (Ex. 14, p. 7) IPW witness Lassance testified that IPW files cases when it needs to file and not on any scheduled basis. (Id.) He argues that because IPW's service area has not experienced any significant growth, that makes filing rate cases on a regular basis necessary. He suggests that past history of filings in no way means that future filings will follow the same timing sequence and that any known significant changes should be factored into the expected rate case filing schedule and the amortization of rate case expenses. Id. Mr. Lassance stated that Interstate will be experiencing expense increases for investigation and remediation of former manufactured gas plants in Minnesota over the next several years and expense growth in the

Conservation Improvement Programs. Given the magnitude of these two items, IPW believes it will be forced to file rate cases for recovery of these items on a much more frequent sequence than it has in the past. Ex. 14, pp. 7-8 Thus, IPW contends that the 3-year amortization period would be far more appropriate given what is known to exist for future cost recovery needs. Ex. 14, p. 8.

82. Under Interstate's proposal, if the estimate of five years between rate cases turns out to be correct, Interstate would collect $265,000 (5 x $53,000) plus a return on $134,132 over the next five years for its rate case expense of $160,000. This is a potential over-recovery of in excess of $100,000. Over the last four years, the Company had the opportunity to recover approximately $115,000 in rate case expense associated with its last rate case while it incurred only $66,980 in rate case expense for that time period. Ex. 32, p. 5.

83. DPS witness Bender would allow the Company an annual average expense of $32,100 per year. Ms. Bender considered several factors in deciding on the average annual level of rate case expense, of $32,100 per year including: (1) the fact that the company has historically filed a rate case every five years; and (2) a comparison of what Interstate actually spent on its last rate case ($72,189) versus its estimated recovery in rates ($115,477). Ex. 31, pp. 4-6. OAG witness Nelson also proposed that five years was a more appropriate time period than three years based upon Interstate's history, and also recommended that $32,000 of expense be allowed. Ex. 21, p. 13.

84. As stated above, the Company proposed to include $134,132 in rate base as an unamortized balance of rate case expenses. DPS witness Bender proposed that all unamortized rate case expense be eliminated from rate base. Ex. 31, p. 7. Ms. Bender's position was that recognition of rate case expenses should be accomplished in the same manner as other expenses that vary from year to year--through the inclusion of a "reasonable, average, annual level in test year operating expenses." Ex. 32, p. 1.

85. In this case, the Company's unadjusted actual test year, 1994, did not include any rate case expenses. Ex. 31, p. 2. However, because a test year should be representative of the average annual operations of the utility for a normal year, the Commission should allow inclusion of an average annual amount of rate case expenses in the test year. Ex. 32, p. 2.

86. Recording an unamortized balance for rate case expenses violates accounting principles because the process of estimating average expenses does not create a capital asset. A capital asset is necessary to produce an unamortized balance. Ex. 32, p. 3. Minn. Stat. § 216B.16, subd. 6, which delineates items to be included in rate base on which the utility is to be allowed to earn a return, limits such a return to "expenses of a capital nature." Since no capital asset or unamortized balance of rate case expense exists, it should not be reflected in Interstate's rate base.

87. Interstate's justification for its proposal to record rate case expenses as an asset in rate base is to recognize the time value of money. However, Interstate has not demonstrated that this concern is justified. As stated above, Interstate did not incur any rate case expenses in 1994, yet it recovered $28,869 (the annual amount allowed in rates in Interstate's last rate case) in rates in that year for rate case expenses. It continued to recover that amount on a pro rata basis until implementation of interim rates on June 30, 1995, at which time it started collecting $53,653 per year in rates for rate case expenses, which it will collect until final rates are set. The major costs (regulatory costs) associated with this rate case will not be billed and paid until some time in 1996. Ex. 32, p. 5. Thus, even under the Department's proposal, Interstate will

have recovered for rate case expenses for most of two years, 1994 and 1995, before it is billed the majority of costs associated with the case.

88. The ALJ finds that Intestate's past history in filing frequency is appropriate basis for determining the appropriate amortization period, particularly given the potential for over-recovery. Interstate has shown no reason to that rate case expenses will likely increase because of manufactured gas plant cleanup expense increases or CIP expense increases. Based upon history and using Interstate's estimate of total rate case expenses, Interstate's proposed rate case expenses should be reduced by $21,553 to $32,100. Ex. 44, (Stp. 37), column (f).

89. Interstate has not met its burden of proof to show that it will lose any time value of money or that for any other reason this rate base addition is appropriate. Therefore, Interstate's proposed test year rate case expense should be reduced by $21,553 to reflect an average annual expense of $32,100 and rate base should be reduced by $134,132 to remove any hypothetical "unamortized balance" of rate case expenses from rate base.

Net Plant In Service

90. Interstate's proposed rate base included thirteen-month average test-year plant balances. DPS witness St. Pierre proposed to use December 31, 1994 plant balances rather than Interstate's proposed thirteen-month average test-year plant so as to be consistent with the Department's use of December 31, 1994 customer counts in its sales forecast. Ex. 41, p. 5. Implementation of this adjustment increases net utility plant and thus, rate base by $199,738. Ex. 44 (STP-4), col. 1. Since the Department's forecast is used to calculate revenues, this adjustment should also be made.

CIP Tracker Adjustment

91. As is discussed in the conservation cost recovery portion of this Report, acceptance of the Department's proposal for recovery of the Conservation Improvement Program (CIP) tracker balance requires a reduction to rate base of $250,809. Ex. 44 (STP-34), col. 2. Interstate has agreed to this method of recovery. Ex. 9, p. 3.

Cash Working Capital

92. Adjustments to rate base and operating expense affect the calculation of the lead/lag study and thus necessitate a recalculation of the cash working capital amount resulting in a reduction in rate base of $25,413. Ex. 44 (STP-34), col. 4.

OPERATING REVENUES AND EXPENSES

Manufactured Gas Plant Cleanup Costs

93. Interstate requested recovery of $4,940,173 in cleanup expenses associated with former manufactured gas plants (MGPs) located in Rochester and Albert Lea. Ex. 6, p. 4. This figure represents Interstate's expenditures for investigation and remediation activities at these two MGP sites for the period of July 11, 1994 through March 31, 1995. Id. The Rochester MGP site remediation is almost complete, while the Albert Lea MGP site is in the investigation phase with no remediation undertaken yet. Ex. 1, pp. 4, 8. Consequently, almost all of the MGP expenses for which Interstate seeks recovery in this case are associated with the

Rochester site ($4,823,770 or 97.6%); the Albert Lea site accounts for a very small portion of the total MGP expense ($116,403 or 2.4%). Ex. 41, p. 6.

94. Interstate shareholders paid $378,332 of expenses for the Albert Lea site, (Ex. 1, p. 4, l.) and $598,593 of expenses for the Rochester site, (Ex. 1, p. 9), prior to Interstate's July 11, 1994, deferral request. Interstate does not seek recovery of these amounts.

95. Because MGP costs represent a very large expense relative to Interstate's total gas revenues, the Company has proposed recovering the $4,940,173 in MGP expenses over a 15-year period, including carrying costs at an 8.5 percent interest rate. Ex. 8, pp. 4-6. The resulting annual expense for ratemaking purposes would be $594,898, which accounts for about one-fourth of Interstate's total proposed rate increase. Id., p. 6; Tr. p. 39.

96. The Department and the OAG opposed Interstate's request for recovery of MGP expenses. The Department argued that Interstate had not met its burden of demonstrating that either of its MGP properties were ever used or useful in the provision of natural gas service to Interstate's natural gas ratepayers. Based on the following findings, the ALJ concludes that Interstate should be allowed to recover one-half of the deferred MGP expenses.

97. The Minnesota Public Utilities Commission has considered recovery of remediation expenses for manufactured gas plant sites for three other companies and in each case allowed recovery of MGP investigation and remediation expenses:

a) NSP at its Faribault site, Docket No. G-002/GR-85-108; and Docket No. G-002/GR-86-160, Jan. 27, 1987.

b) Minnegasco at two sites, Docket No. G-008/GR-93-1090, October 24, 1994; and Docket No. G-008/GR-92-400, May 3, 1993.

c) Peoples at the Rochester site, Docket No. G-011/GR-92-132, Feb. 22, 1993; and in the same docket "Order Denying Reconsideration" June 11, 1993.

98. The Commission has stated that in the absence of negligence or misconduct, the utility should be entitled to recovery of the expenses mandated by the MPCA. NSP, Docket No. G-002/GR-86-160, p. 11, January 27, 1987. The Commission has also set forth the requirements which must be met in order to recover MGP remediation expenses. The Commission has clarified its decision regarding recovery of MGP expenses by stating:

> The Commission found a sufficient nexus between the past costs incurred and present ratepayers from the fact that the property had been used and useful at the time the pollution of the land occurred. Because the cleanup costs were tied to the normal provision of utility service and the property was used and useful in the provision of that service, the MGP cleanup costs were recoverable in rates.

Peoples, Order Denying Reconsideration, Docket No. G-011/GR-92-132, June 11, 1993, p. 4.

99. No party contests the prudency of the MGP expenses. The DPS and the OAG, however, argue that Interstate's MGP expenses for the Rochester and Albert Lea sites do not meet the "used and useful" standard established by the Commission, and recommend that these costs be denied.

100. The Commission also has expressed its policy that MGP property must be used and useful to the specific class or set of ratepayers from which cost recovery is sought. When Interstate requested permission to defer MGP costs into the current rate case, it also requested permission to allocate these costs between its electric and natural gas operations for recovery from both sets of ratepayers. Interstate argued that electric service displaced some uses of manufactured gas--lighting, cooking and heating--creating a nexus between manufactured gas and electric service. The Commission rejected this argument, stating:

> Interstate's displacement argument is not persuasive. As the Department noted, electric service uses a completely different generation, transmission, and distribution system from manufactured gas service. Wholly different fixtures and appliances were required for customers to make the switch from manufactured gas service to electric. The factual nexus is too strained to support allocating cleanup costs to electric customers.
>
> Neither does the Commission agree with Interstate's argument that the character of these costs as environmental means that they must be treated differently from other costs, allocated to both electric and gas ratepayers if the MGP site was at one time used and useful to the utility. The Company cites nothing in statute, rule, or Commission precedent which sets allocation of environmental costs apart from other cost allocations. Electric customers have not been benefited by the MGP generation, distribution, or transmission system, and should not be burdened by the costs of MGP cleanup.

<u>Interstate Power Company</u>, Docket No. G001/M-94-633, Order Denying Reconsideration, dated August 21, 1995, p. 4.

101. Interstate and its predecessors have provided gas service in Albert Lea since 1903. Ex. 1, p. 2-3. Manufactured gas was provided from the plant from 1903 until it was displaced by natural gas service in Albert Lea in 1933. <u>Id</u>. One portion of the Albert Lea site was used as a garage and warehouse for utility operations for a number of years. Ex. 2, p. 13. This property was eventually sold. Ex. 1, p. 3. The other MGP site property is still owned by Interstate and is currently used for underground electric and gas facilities. Ex. 1, p. 3.

102. Interstate and its predecessors provided manufactured gas service in Rochester from 1888 through 1932. Ex. 1, p. 6. From 1932 until 1948, Minnesota Northern Natural Gas leased the gas plant, property and system from Interstate for use in providing the natural gas service which displaced manufactured gas service. <u>Id</u>.; Tr. 23.

103. In 1994, the Minnesota Pollution Control Agency entered a consent order requiring remediation of the Rochester site. Ex. 1, p. 8. Interstate, Peoples and the City of Rochester reached various settlement agreements regarding investigation and remediation expenses which have avoided costly and time consuming litigation. Ex. 1, pp. 8-9. Interstate is pursuing third parties, including insurance carriers, for Rochester and its other MGP sites in relation to the remediation expenses. Ex. 1, p. 10.

- <u>Manufactured Gas v. Natural Gas/Used and Useful</u>

104. The principal argument raised by the OAG and DPS is that the sites are not used and useful for <u>natural</u> gas customers because the provision of manufactured gas is a different utility from the provision of natural gas. This argument must be rejected because it is

contrary to Commission precedent and the common sense upon which the Commission precedent is based. As quoted above, the Commission has twice ruled that Interstate's MGP cleanup costs are related to the provision of gas utility services, not electric utility services. And common sense tells us that manufactured gas and natural gas are much alike; they are both combustible, gaseous substances distributed to customers through piping and used by the customers for heat and light. The fact that one was created locally and the other brought in by pipeline is just a matter of science and economics. We would not call electricity generated locally a different utility from electricity purchased from a remote provider, and there appears to be no logical reason to do so with the two types of gas. The DPS and OAG have cited no authority that agrees with their argument.

105. At the time "manufactured" gas was provided, it was the only gas available, (Ex. 1, pp. 3, 7) and as "natural" gas became available it displaced "manufactured" gas. Id. & Tr. 275. The Company admits it previously provided evidence indicating the cost of natural gas resulted in greater uses for heating, and that the greater predominance of electricity displaced some of the prior uses of "manufactured" gas. The Company made these statements in relation to its position that the costs should be spread to electric customers in a deferral docket. But, the Commission rejected the Company's position in the deferral docket. Order Denying Reconsideration (Deferral Docket G-001/M-94-633), August 21, 1995, p.4.

106. Interstate gas customers were served with manufactured gas until the time natural gas displaced this service. Ex. 1, pp. 3, 7. In Rochester the displacement also coincided with the loss of Interstate's franchise to provide gas service. Ex. 1, p. 7. Each of the sites provided normal gas utility service at the time of pollution, (Ex. 1, pp. 2-3, 6) and were also later used in providing natural gas service (although not by Interstate in Rochester). Ex. 1, pp. 3, 6, Ex. 2, p. 13, and Tr. 23.

107. The previous Commission decisions do not specify that a site had to be found used and useful for natural gas utility services at the time of pollution. For example, in the decision allowing recovery for the expenses at the Faribault MGP site, the Commission found a sufficient nexus between past costs incurred and present ratepayers because the "property had been used and useful at the time of pollution." NSP, Docket No. G-002/GR-85-108, p. 22. The Commission found no need to consider the generation source of the gas in concluding a sufficient nexus existed. See Peoples, Order Denying Reconsideration, Docket No. G-011/GR-92-132, June 11, 1993, p. 4 (clarifying NSP decision). Obviously, the Commission was aware that at the time of the pollution it was manufactured gas that was being provided by the companies.

108. This nexus also exists for Interstate at the Rochester and Albert Lea MGP sites and makes recovery of the expenses appropriate. The use of the site as a manufactured gas plant is the specific factor satisfying the "used and usefulness" requirement for both NSP at Faribault, and Interstate at Rochester and Albert Lea, because this is the "use" "at the time of pollution" to which the Commission refers. It is also this use which has now been found by the MPCA to necessitate remediation. When used as a manufactured gas site, normal gas utility service was provided to Interstate customers. The gas provided was "manufactured" gas, however, this is also the type of gas utility service produced "at the time of pollution" at the NSP Faribault MGP site.

109. The production and distribution of manufactured gas constitutes utility service. The Commission has not distinguished between manufactured and natural gas previously and no basis exists to do so now. Both the Albert Lea and Rochester sites were used and useful in

the provision of gas utility service at the time of pollution and, therefore, recovery of these expenses is appropriate.

110. The DPS and the OAG claim that the Albert Lea site never provided "utility service" or served "natural" gas customers. DPS witness St. Pierre, in Ex. 41, p. 13, asserts "Interstate never used the Albert Lea MGP site for the benefit of its natural gas customers." This assertion relies on the distinction between "natural" and "manufactured" gas that has been rejected above.

111. Moreover, IPW witness Chase explained the specific uses of the land to serve natural gas customers:

After the FMGP ceased operations this site housed a garage and a warehouse. In fact the old gas holders were converted to a garage and a warehouse that IPW used for a number of years.

Ex. 2, p. 13, and response to DPS Data Request 148(a). Although it is not entirely clear, Mr. Chase's testimony indicates underground gas facilities on the property are currently used to serve natural gas customers. Ex. 1, p. 3. Interstate also used the land for utility services both at the time of pollution (for production of gas) and later (as a garage and warehouse).

112. The ALJ can find no significant factual distinction between the Commission decision in the NSP case regarding Faribault, NSP, Docket No. G-002/GR-85-108, and the facts of Interstate's MGP site at Albert Lea. The Commission found the Faribault site to be used and useful not because the plant produced natural gas and served natural gas ratepayers, but because the site had been used in the normal provision of utility service at the time of pollution. Id. The Albert Lea site is used and useful for the same reason.

113. Because the Albert Lea site cannot be factually distinguished from the Faribault MGP site, the used and useful standard is satisfied, and recovery is appropriate.

- Current Customers in Rochester

114. Interstate lost the franchise to serve gas in Rochester in 1932. Ex. 1, p. 6. As a consequence, Interstate does not currently serve gas customers in Rochester. The DPS asserts the lack of current customers in Rochester is a basis for denial of recovery because this means the site was never used and useful. Ex. 41, p. 8.

115. The DPS and OAG argue that each of the other companies that have been allowed recovery still have customers in the town in which recovery was allowed; Peoples at Rochester, Ex. 41; NSP at Faribault, Ex. 41; and Minnegasco in Minneapolis areas, Ex. 41, p. 11. However, Ms. St. Pierre admitted that a Company is not required to serve customers in the town in which remediation occurs in order for the MGP site expenses to be recoverable. Tr. 230.

116. The OAG argues the lack of current customers in Rochester is relevant because the customers who received the gas services will not pay the costs of the cleanup. The OAG witness asserts that because Faribault is located in NSP's gas service territory, "at least some of the MGP cleanup costs will be recovered from ratepayers who benefited from the use of the site." Ex 22, p. 3.

117. In the NSP rate case involving Faribault the Commission did not find that customers who received service from the MGP would be paying the costs of cleanup. Instead, the Commission found that the site was "used and useful at the time of pollution" in the normal provision of utility service. This was a sufficient nexus with current ratepayers. Such nexus existed with all current ratepayers, not just those in Faribault.

118. Because the Commission did not directly assign the costs of the Faribault MGP site only to NSP gas customers in Faribault, the Commission has implicitly rejected the approach advanced by the OAG and DPS. No basis exists for distinguishing Interstate's expenses for the Rochester MGP site because Interstate does not have current customers within the City of Rochester.

119. The OAG argues that current customers receive no benefits from the Rochester cleanup expenses. But, the Commission has previously indicated that prompt attention to MGP site remediation will likely benefit gas ratepayers by minimizing environmental litigation or fines. Order Allowing Deferral, April 13, 1995, p.4. Fines may not be recoverable in rates, but the avoidance of litigation and environmental agency displeasure are valuable, cost-saving benefits to the Company and , ultimately, the ratepayers.

120. Recovery of expenses in Rochester is appropriate. The lack of current Interstate customers in Rochester is not a basis for denial. The lack of customers is not inconsistent with previous decisions or general ratemaking principles. Recovery is consistent with the Commission's policy to allow recovery for prudent, reasonable, MPCA mandated environmental remediation expenses. As stated by the Commission in the Peoples case:

> It is clear that the City of Rochester and Interstate Power Company are in a similar position. To avoid losing control over the timing, conduct, and costs of remediation, the three parties have signed an agreement to cleanup the site, split the costs equally, and argue over proper cost allocation later. This is a reasonable approach to pollution abatement which the Commission will not discourage by being ambiguous about cost recovery.

Peoples, Docket No. G-011/GR-92-132, February 22, 1993, p. 11. Interstate's lack of current gas customers in Rochester is not a reason to disallow recovery.

- Company Statements in Annual reports

121. The Company acknowledged to its shareholders the uncertainty of rate recovery for its MGP costs based on prior Commission precedent. In Interstate's 1993 Annual Report, cited in Ex. 21, p. 7, it was stated that it was uncertain whether the company would recover any uninsured costs applicable to the Rochester site because the company no longer served that city and no Minnesota precedent had been established for recovery in a similar situation. In its 1994 Annual Report, the Company, again, indicated that it was doubtful that the Company could recover all the MGP costs applicable to its Minnesota jurisdiction. See, IPW's Annual Report, pp. 24-25. These statements indicate that the Company itself has doubts as to the recoverability of these expenses and suggest to shareholders that they may have to absorb the expenses.

122. Interstate similarly discussed recovery with its Board of Directors in a statement by Mr. Chase, in his role as the Officer in charge of the investigation and remediation of these sites. (This statement was not made by the Chairman of the Board as incorrectly stated by the

DPS witness Ex. 41, p. 12. Mr. Chase does not hold this position.) The Company has a duty to inform its Board of potential risks. Tr. 257.

123. The DPS and OAG claim that Interstate's discussion of MGP sites with its shareholders and Board of Directors is relevant and an indication that the Company did not expect recovery of these expenses. The Company argues these discussions with shareholders and its Board are not relevant to determination of recovery. The OAG and DPS admit that it would be inappropriate to give weight to Company statements to shareholders or the Board had those statements indicated that the Company was entitled to recovery. Tr. 258, 118.

124. The statements made to shareholders and the Board of Directors are not binding admissions by the Company that the deferred MGP expenses should not be recovered in the rates. Their only real significance in this proceeding are that they make it clear that the Company and its shareholders are well aware that they may have to bear some or all of the cost of the remediation.

- Recognition of Expenses in Financial Statements

125. The Company took the unusual step of writing off all of its expected Rochester MGP cleanup costs from 1991 through 1993 rather than exercising its prerogative of seeking timely deferral of these costs. Ex. 41, p. 17. Other Minnesota utilities--particularly Peoples, which shares liability for the Rochester MGP site--sought deferred accounting and rate recovery as soon as possible in order to avoid the need to write off MGP expenses. Peoples Natural Gas Company, Docket No. G001/GR-92-132, Findings of Fact, Conclusions of Law, and Order, dated February 22, 1993, pp. 11-12. Interstate's shareholders would not normally expect Interstate to reverse the expensed costs at a later date because it is extremely rare for companies to reverse non-tax costs which have already been expensed. Tr. 157. The DPS and OAG argue that these statements and actions by Interstate, while not by themselves determinative of whether MGP costs should be recovered in rates, give a clear indication of the Company's own opinion as to the ultimate recoverability of these costs. Again, this fact is mostly irrelevant to this matter except to the extent that it indicates that the Company and its shareholders know of the possibility that all of the deferred costs will not be recovered in the rates and that this fact has been factored into shareholders' consideration of their investment risk.

126. The Company's position is that it complied with SEC requirements in its accounting treatment of these expenses on its financial statements. This compliance recognized current liabilities and did not recognize a likely recovery in the form of a regulatory asset because the recovery was not certain and because of factors unique to Interstate which made the potential non-recovery material. This was done in compliance with SEC requirements requiring the recognition of the best estimate of known material liabilities Ex. 2, p. 10-11. The Company's method has resulted in the unrecoverable expenses being recognized in the appropriate financial period. Although the Company's method results in a recognition of recovery in a later financial period because recovery becomes definite, this is consistent with SEC accounting rules. These rules require recognition of an estimate of a known liability, but do not allow a recognition of recovery regarding that liability unless definite. The OAG witness concedes this is correct. Tr. 120. The DPS witness does as well. Tr. 264-5.

127. Interstate's treatment of these expenses for financial statement purposes does not drive the regulatory decision regarding these expenses. Ratepayers will pay no more or no less than they would if Interstate had accounted for the expenses in a different manner on its

financial statements. The deferral order sufficiently places the expenses before the Commission. The Company has shown the expenses were reasonable and prudent and has satisfied the used and useful requirement. The DPS and OAG have not shown that the Company violated any Commission accounting rule or procedure which would justify disallowal of these otherwise recoverable expenses.

• Shareholder Expectations/Inducement for Pursuing Third Parties

128. The DPS and OAG assert that expensing these amounts removes any shareholder expectation of recovery. The Company states the comments of actual investors at the public hearings in this docket contradict the DPS and OAG positions. Informed investors are no doubt aware of the Commission's allowance of recovery for every other investor-owned utility that has been before the Commission on this issue and likely have an expectation of some recovery.

129. The DPS and OAG also contend that these costs should not be recovered from ratepayers because they assert recognition of the previous liabilities was borne by shareholders without detrimental impact. In fact, Interstate's testimony indicated that there was a detrimental financial impact to shareholders from these recognized liabilities. Ex. 2, p. 9. This is not contradicted. Tr. 268. Further, this theory is not a sound basis for a ratemaking determination. It is not a generally accepted ratemaking principle that shareholders should bear all expenses until a detrimental impact is shown.

130. The ALJ does agree with the OAG argument that the relationship between shareholders and the Company is quite different from Interstate's relationship with ratepayers. Tr. 158. Shareholders voluntarily assume the risk that certain costs or circumstances will effect their investment in Interstate. Ratepayers, on the other hand, do not voluntarily assume such risks. Tr. 274. At that level, the equities in this case favor the captive ratepayers who are in no way responsible for the pollution and have not assumed the risk of unforeseen liabilities. However, there are additional equities to consider in light of the societal good of environmental cleanup. Those equities have been weighed previously be the Commission and have been found to justify contribution from the ratepayers.

131. The OAG argues that if recovery of the MGP costs is guaranteed through rates, Interstate would have a reduced incentive to recover the costs from other parties. Interstate has been and still is aggressively pursuing third parties. The DPS and OAG raised no specific issues relating to reasonableness or prudence of Interstate's strategy pursuing third parties. The Company suggests that the comment that Interstate has no incentive to pursue low rates completely ignores current financial reality in which utilities operate.

132. The Commission has found adequate oversight provisions relating to recovery from third parties in relation to other utilities' recoveries. To suggest that Interstate should not be allowed recovery because to do so would remove economic incentive to pursue third parties is inconsistent with general ratemaking principles. The cost-spitting result recommended by the ALJ will provide more that sufficient inducement to the Company to minimize the cleanup costs every way it can.

• Recovery of MGP Expenses and Carrying Charges

133. The Company has shown that the expenses for the Albert Lea and Rochester sites are recoverable. The facts surrounding the expenses clearly fall within the Commission's

previously stated policy allowing recovery of MGP expenses. The expenses are mandated by the MPCA; they are reasonable and prudent; and the sites were used and useful at the time of pollution as well as later used and useful in the normal provision of utility service.

134. The DPS and OAG both suggest no carrying charge is appropriate because the Commission did not allow a carrying charge on similar expenses in an NSP case. Docket G-002/GR-86-160, Jan. 27, 1987, p. 11. That was the method chosen by the Commission to approximate an equal sharing of the cleanup expense between shareholders and ratepayers. They suggest it should be applied here as well.

135. The Company's position is that a carrying charge is appropriate on amortization of the recovery of these expenses. The Company points out it has proposed a recovery of these expenses over fifteen years, significantly longer than the five years in the NSP case. The Company argues that if no carrying charge is allowed based on the fact that NSP was allowed no carrying charge, then the Company should be allowed to use the shorter five year period for amortization as well. It also points out that Interstate shareholders already incurred nearly one million dollars of the expense prior to the deferral request, which it calls a sufficient sharing.

136. The ALJ finds that Interstate should be allowed to recover 50 percent of the deferred expense of $4,940,173. The facts of this case and the arguments of the parties demonstrate that both shareholders and ratepayers should contribute equally to the cleanup. The expenses incurred before Interstate's petition for deferral are not an issue in this case and cannot be considered.

137. The ALJ also finds that simply denying carrying costs is too loose an approximation and that it would be more appropriate to divide the expense by two and amortize it over an appropriate period with a carrying cost. While the company has proposed a carrying charge of eight and one-half percent, the reduction of interest rates since the filing of this case suggests that eight percent is now more appropriate. Amortizing $2,470,087 over 15 years at eight percent requires annual installments of $288,579 and over 10 years at eight percent requires installments of $368,116. The ALJ finds that the size of the rate increase in this case justifies the 15 year period.

Post retirement benefits other than pension (PBOPs).

138. DPS witness Gilberstadt evaluated the reasonableness of Interstate's proposed test-year compensation costs including PBOP expenses. Ex. 30. Interstate requested $60,610 in PBOP expenses to reflect the adoption of FAS 106 accrual accounting and also requested amortization of deferred PBOP costs over three years, resulting in a test-year expense of $73,258. Ex. 30 (SLG-1, 2).

139. Interstate proposed to externally fund its PBOP obligation through a Voluntary Employee Benefit Association (VEBA) for union employees so that all contributions will be fully tax deductible in a 401(h) account. Ex. 30, pp. 5-6. The Department agreed that using a VEBA and a 401(h) account to fund union and non-union employees' PBOPs is reasonable and appropriate. Id., pp. 8-10.

140. Interstate's funding mechanisms are reasonable, providing tax benefits and assurance that Interstate will have the necessary funds to pay employees' non-pension post retirement benefits and provide assurance that funds collected to pay non-pension post retirement benefits will be used for this purpose. Ex. 30, p. 11.

Other compensation costs.

141. The Department evaluated Interstate's overall test-year compensation package, including base pay and benefits and concluded that those expenses are reasonable. Interstate does not offer incentive compensation. Ex. 30, p. 11.

142. Interstate's goal in compensation is to be competitive with the external marketplace and provide internal equity among all positions in the Company. Ex. 30, p. 12. Interstate used a method of determining market comparability that is widely used and similar to that used by Minnegasco and Minnesota Power. Id. at 12.

143. Interstate's compensation costs are within 105 percent of the market median. The Commission has accepted test-year compensation costs that fall within 105 percent of the median market for Minnesota Power, Minnegasco and Northern States Power Company (NSP) Gas and NSP Electric. Id., p. 13. Interstate witness Hamill compared Interstate, NSP, Otter Tail Power Company and Minnesota Power as to total compensation expense per average employee and found Interstate's to be comparable to those other Minnesota utilities. Ex. 7, pp. 4-5.

144. No party opposed recovery of Interstate's test-year compensation and PBOP costs.

145. Interstate's test-year compensation expenses, including its nonpension post retirement benefits are reasonable and should be allowed in the rates.

Allocations Between Regulated and Unregulated Operations.

146. The Company allocates expenses between: 1) regulated and nonregulated operations, 2) gas and electric operations, and 3) three state jurisdictions. Interstate has nonregulated merchandising, jobbing and contract operations and a wholly owned nonregulated subsidiary, IPC Development Co., that operate outside of Minnesota. Ex. 4, pp. 1-3. Interstate does not sell appliances or appliance service contracts nor does it provide agency services. Ex. 31, p. 9. It is IPW's policy not to engage in that type of activity. When IPW's gas personnel are approached about merchandise sales, IPW provides the name and address of its supplier. With regard to inquiries about jobbing, IPW refers such inquiries to local business that might do the desired work or could make the appropriate referral. Ex. 14, p. 9

147. Interstate has adopted most, but not all of the four cost allocation principles endorsed by the Commission in its September 28, 1994, Order Setting Filing Requirements in Docket No. G-E999/CI-90-1008. Ex. 4, pp. 4-7. Department witness Bender concluded that Interstate has not adopted the fourth principle which requires the use of a general allocator to allocate costs for which neither direct nor indirect measures of cost causation can be found and may only partially apply the third principle regarding allocations based upon indirect cost-causative linkages. Ex. 31, pp. 10-12.

148. However, that September 28, 1993 Order provides for an exception where nonregulated operations are insignificant. Ex. 31, p. 10. Department witness Bender reviewed the cost assignment and cost allocation practices of Interstate. Both DPS witness Bender and Interstate witness Troy agreed that Interstate's nonregulated activities are insignificant. Id., p. 10; Ex. 4, p. 7. Because of this, Ms. Bender found that it would not be cost-effective to

require Interstate to adopt fully the Commission's preferred approach to apportioning costs between regulated and nonregulated activities. Id., p. 12.

149. Interstate allocates 100 percent of the common corporate expenses among its regulated activities. Tr. 25-26. The Company does not allocate common corporate administrative and general (A&G) expenses to its nonregulated activities. Because of this, the cost of some of its common corporate A&G services used by its unregulated operations are, in effect, allocated to Minnesota gas utility operations. The Department proposed an adjustment to correct this allocation. Ex. 32, p. 8. Ms. Bender calculated the required adjustment to be a reduction of $1,397 to test year A&G expenses. Ex. 31, p. 13; (SLB-14); Ex. 44 (STP-37), col. (g), line 8.

150. Interstate argued that since it does not engage in nonregulated activities in its Minnesota gas jurisdiction, no cost allocation should be made when setting Minnesota rates. Ex. 14, p. 10. It argues that the activities are so immaterial as to not warrant consideration and that the DPS adjustment would shift prudently incurred costs from its regulated side to its nonregulated side, with no opportunity to recover the expenses.

151. If an unregulated cost center or business division of Interstate used corporate resources and thus generates A&G expenses, it should absorb its share of these costs. If those A&G expenses are not properly allocated to unregulated operations prior to those costs being allocated to Minnesota, Minnesota ratepayers will end up paying for some unregulated operations in rates. Ex. 32, pp. 8-10.

152. The ALJ finds that the DPS's allocation of a portion of the main common administrative and general cost categories of officers and general office salaries and expenses and employee benefits to the nonregulated operation using a general allocator should be adopted by reducing test year A&G expenses by $1,397.

Economic Development Expenses

153. IPW's filing included $8,830 in its test year cost of service (in account G930.35, economic development) expenses associated with economic development. The Department recommend that these expenses be disallowed because Interstate failed to show that the benefit of its economic development programs exceed the costs. Ex. 33, p. 15.

154. The Department requested detailed information to assist it in performing a cost-benefit analysis of these programs. The Company failed to provide any information for most of its programs. Ex. 33, p. 16-17. On the one program for which the Company did provide data, the Department felt that data was not sufficient to support recovery. Ex. 33, p. 17.

155. Interstate testified that it did not have the requested information available because it had never previously been asked for such detail as contribution to IPW's peak day gas use per customer receiving economic development assistance, in previous rate cases had received recovery of economic development expenses without providing detailed cost vs. benefit analysis, and had recovered economic development expenses in Iowa rate cases without the detailed analysis demanded by the DPS. IPW witness Peterson testified that IPW's economic development expenses in Minnesota have been relatively minor and that IPW did not believe that the time and money necessary to set a more expensive meter and develop a cost/benefit model would be an appropriate use of IPW's resources to recover $8,830. Ex. 3, p. 1.

156. Mr. Peterson further argued that small to medium sized projects such as those included in IPW's rate filing will typically generate more revenue indirectly through sales to employees and suppliers of the assisted industry. Additionally, he believed that the benefit or effects of IPW's efforts are not immediately evident. He agreed that IPW must leverage its one-person Economic Development Department to maximize its efforts over the three states IPW serves by funding local or regional economic development efforts and that Minnesota's business climate has caused IPW to become more involved in economic development. Ex. 3, pp. 1-2.

157. Minn. Stat. § 216B.16, subd. 13, gives the Commission the discretion to allow recovery of economic development costs, but does not mandate recovery of such costs. The Department argues that costs for any program that have not be shown to be cost-beneficial for the operation of the utility should not be recovered from ratepayers and that Interstate had the burden of proof on this issue and Interstate made no showing that these costs provide a net benefit to ratepayers.

158. The Department also argues that if the Commission determines that these programs are effective, the Commission should allow only 50 percent of these costs. Since stockholders as well as ratepayers benefit from the programs, the cost should be shared. This would be consistent with the Commission's Orders in Docket Nos. E002/GR-91-1, pp. 40-42 and E015/GR-94-001, pp. 31-32, which allowed recovery of one-half of cost-beneficial economic development costs in rates. Ex. 33, p. 18.

159. The ALJ finds that the Company’s economic development costs should be allowed at the rate of 50 percent. Thus, $4,415 should be disallowed from IPW’s proposed expenses. The costs were incurred, but requiring the installation of expensive meters to measure the impact would be useless at this low level of expenditure. It can be fairly assumed that there was some beneficial impact from the activities in Minnesota. However, Interstate should be required in its next rate case to provide a more detailed specification of its Minnesota economic development activities and results so that the benefits can more easily be determined.

Property Taxes.

160. Interstate proposed using an estimate for its 1994 property taxes, the 1994 "accrued" taxes, as its test-year amount of property taxes to be recovered in rates. Ex. 41, p. 17; Ex. 42, p. 11. Interstate witness Lassance explained the Company's position that "accrued property taxes would be more representative of what this expense item will be in the future . . ." Ex. 14, p. 5.

161. The Department opposes Interstate's proposed treatment for property taxes because it does not comport with the Company's choice of a 1994 test-year.

162. DPS witness St. Pierre explained that in a historic test-year, actual costs are used and the costs can be adjusted, if necessary, for "known and measurable" changes. Ex. 41, p. 3. The Company's proposal to use 1994 accrued taxes is not a known and measurable change because it is not based on what the Company knows its 1995 property tax level will be. Instead, it is simply an estimate of what the Company thought its 1994 taxes would be. Ex. 42, p. 11.

163. The Department's proposed that the 1994 actual property tax amount be used. That is consistent with the Company's choice of a 1994 test-year, is the known and correct

amount, and should be adopted. The Department's proposed adjustment decreases Property Tax expense by $8,797.

Test Year Sales Forecast

164. The Department and Interstate each forecasted test year sales. Ex. 13, p. 3-10; Ex. 39. The two forecasts, considering the correction in the base cost of gas included in Ex. 44, differ by only a few hundred dollars. Ex. 14, p. 4. Thus, while the methodology of the two parties differed, the results were substantially the same and the parties stipulated that the numbers were reasonable without agreeing to the methodology. The Department's calculation of revenues included in Exhibit 44, Sched. C-1, pp. 1-2 should be used for calculating rates in this proceeding.

Rate Case Expenses.

As discussed in the rate base section, and for the reasons stated there, test year rate case expenses should be reduced by $21,553. Ex. 44 (STP 37), column (f).

CONSERVATION COST RECOVERY

Existing CIP Tracker

165. In Docket No. G001/M-90-899, the Commission approved Interstate's tracker account, with a conservation cost-recovery charge to be built into rates, for its Conservation Improvement Program (CIP). In this case, Interstate requested recovery of its CIP tracker balance, which as of June 30, 1995, equaled $645,307. This reflected a modification to the tracker required by the Commission's May 5, 1995 Order in Docket No. G001/M-94-1034. Ex. 33, p. 3; (FL-2).

166. The Department recommended recovery of the tracker balance with a reduction of $48,908, plus $10 in associated carrying charges, the amount by which Interstate exceeded its budget, as approved by the Commissioner of the Department in the CIP process. Thus, the Department recommended recovery of $596,389 for the CIP tracker ($645,307-$48,918). Ex. 33, p. 4.

167. On July 11, 1995, Interstate submitted a modification to its 1994-95 CIP budget, approval of which is pending before the Commissioner of Public Service. If the Commissioner approves Interstate's request prior to the completion of this case, the Department recommends that full recovery of Interstate's actual tracker balance as of its August 1, 1995 update be allowed. Ex. 34, p. 4 and 5. To date, that approval has not been given.

168. The Department approved CIP tracker amount of $596,389 should be included in rates unless the Commission approves a modification; in which case, the modified amount should be allowed.

Recovery Of CIP Tracker Balance

169. The Commission's usual practice to provide for recovery of the CIP tracker balance is to deduct that balance from the interim rate refund. Ex. 33, p. 5. Both the Company and the Department support that result if possible. However, since it is likely that the refund will be insufficient for this purpose, the parties proposed an alternative method of recovery.

170. DPS witness Lowell recommended that the tracker balance be expensed over five years, and that Interstate's inclusion of half of the tracker balance in rate base be denied. She also recommended that Interstate be required to track its unrecovered balance and that the balance accrue carrying charges in the same manner as the current CIP tracker. The unrecovered balance would be tracked based on actual revenues until Interstate's next rate case. The Commission could then examine the balance of the tracker in the next rate case and allow appropriate recovery at that time. Ex. 33, pp. 6-8. Based on the Department's sales forecast, the cost recovery factor for the recoverable portion of the tracker balance would be $.00514 per therm. Ex. 33, p. 7.

171. In its rebuttal testimony, Interstate indicated it did not object to the Department's proposed recovery mechanism. Ex. 9, p. 3; Ex. 34, p. 5. Therefore, the Department's method for recovery of the CIP tracker balance should be adopted. As a result, Interstate's proposed rate base should be reduced by $250,809. Ex. 31, (SLB-4); Ex. 44, (STP-34), col. 2.

Test-Year CIP Expenses

172. Interstate witness Reisdorf's testimony indicates that it is the Company's intent to expense $254,125 for test year CIP costs. This is the amount approved by the Commissioner for Interstate's 1995-96 CIP in Docket No. G001/CIP-94-316. The Department agreed that $254,125 is the appropriate test year CIP expense. Ex. 33, p. 8; Ex. 34, p. 6. Thus, test-year CIP expense of $254,125 is reasonable and should be included in test-year expenses.

Conservation Cost Recovery Charge

173. Interstate proposed a conservation cost recovery charge (CCRC) of $0.01330 per therm by dividing the proposed test year CIP expense of $254,125 by total normalized test year sales. DPS witness Lowell disagreed with the Company's calculation because Interstate excluded transportation sales in its calculation.

174. The Department correctly used total sales, including transportation, because, as discussed by DPS witness Chavez, the Company recovers the same margin on its transportation volumes as it does through the equivalent sales rates.

175. Any calculation of the CCRC should be calculated by dividing the approved test-year CIP expenses by the approved total test-year sales, including transportation. Ex. 33, pp. 10-11.

RATE-DESIGN

Rate Design Criteria

176. There is general agreement that utility rates should be designed to meet reasonable regulatory goals. The Department's rate-design proposals are based on such goals. Specifically, the rate-design recommended by the Department in this proceeding is based on the following four goals:

a) Rates should be designed to provide the Company a reasonable opportunity to recover all prudently incurred costs, including costs of attracting capital. These rates, matched to test-year customer counts and sales projections, should allow the Company to collect its revenue requirement.

b) Rates should be designed to promote an efficient use of resources. As such, they should reflect the costs that classes of customers impose on the system.

c) Rates and conditions of service should provide a reasonable continuity with the past. Rate-design changes should be reasonable and, to the extent possible, gradual to prevent drastic impacts on existing customers.

d) Rates and conditions of service should be logical, understandable and easy to administer. Ex. 37, pp. 3-4.

177. Rates consistent with these criteria will help ensure that Interstate provides efficient service at reasonable and understandable rates, while minimizing drastic rate changes on customers. It is important to strike a balance among these goals in designing rates.

178. A class cost of service study ("CCOSS") is an important tool to identify cost causation. A CCOSS should identify as accurately as possible which customer class is responsible for each cost incurred by the utility in providing service. No factors other than cost causation should influence a CCOSS. To perform a CCOSS, costs are functionalized or grouped according to their purpose, costs are classified based upon how they are incurred, and, finally, costs are allocated to customer classes. Ex. 23, pp. 1-3.

179. Department witness Kosowski reviewed Interstate's CCOSS by comparing it to the Company's CCOSS filed in its last two rate cases. Ms. Kosowski also focused her investigation on how Interstate allocated costs for those items which either represent large expenditures or have become important due to recent changes in the gas industry as a result of FERC Order 636. Ms. Kosowski reviewed Interstate's allocation of costs which were not explicitly addressed in the last case: conservation, manufactured gas plant, and security deposits. Other items she investigated included costs for peak shaving gas, purchased gas demand, distribution plant and peaking plant, variable operation, and maintenance. The Department's investigation determined that Interstate's allocation of costs were reasonable. Ex. 23, pp. 5-10.

180. The Department prepared its own CCOSS which, for the most part, uses Interstate's cost allocation methodology. Department witness Kosowski, however, recommended that the Company's CCOSS be modified to include a breakout of costs for transportation customers. Ex. 23, p. 10.

181. Since separately allocating costs to transportation customers provides a more accurate picture of cost causation, the ALJ adopts the Department's CCOSS which provides this allocation.

182. Interstate did not prepare a "Minimum Distribution Study" as part of its CCOSS. The Department recommended that the Commission require Interstate to conduct a minimum distribution study as part of its CCOSS with the Company's next rate case.

183. According to Ms. Kosowski, a minimum distribution study is an important part of a CCOSS because it identifies the costs of the distribution system required to provide service to customers, regardless of how much gas they consume. Once identified, these costs represent the minimal costs required to hook up and stand ready to serve each customer. Such costs are

appropriately classified as customer costs and the distribution costs that exceed the costs of a minimum system are classified as capacity costs. Ex. 23, p. 13.

184. IPW witness Berentsen testified that IPW's classification of the costs related to distribution services, regulators and meters as customer-related provides an appropriate basis upon which to establish customer charges. Ex. 11, p. 1. Mr. Berentsen testified that since virtually all of IPW's equipment and facilities utilized to provide gas service are required, regardless of the amount of gas consumed by customers, each distribution plant account will need to be analyzed to determine its customer component. He testified that the services, meters and house regulators comprise 45% ($3,984,000) of the distribution plant that are customer-related and that including all the amounts in the distribution accounts shown above as customer-related would more than double the customer-related plant. Id.

185. Mr. Berentsen does not believe that Interstate should be required to conduct a minimum distribution study because the Department has not specified how distribution facilities should be separated into customer and capacity components or how the customer related portion of costs should be determined. Ex. 11, pp. 1-2. According to Ms. Kosowski, the precise methods used to develop this information cannot be specified before actual data is available. In fact, she was unable to what facilities should be included, but did assume that it would produce greater customer costs than Interstate's current technique. Tr. 163. That is likely so because at least part of the mains would be included.

186. The performance of a minimum distribution study is consistent with the Commission's Order in Peoples Natural Gas, Docket No. G011/GR-86-144 (January 16, 1987). But there are several ways to approach the task of estimating the costs of a minimum distribution system and several judgments to be made in making such a study. The Department has offered to assist the Company in designing an appropriate minimum distribution study if Interstate is unsure of how to proceed. Ex. 23, p. 13; Ex. 25, p. 2. But the Department is unable or unwilling to specify ahead of time the definitions and standards it would require Interstate to follow in conducting such a study. More importantly, the Department has presented no evidence that a minimum distribution study of the type it suggests would improve the cost allocation methodology used by the Company or have any practical benefit. To the contrary, IPW has suggested that its methodology is acceptable because NARUC references the "basic system theory" whereby mains are considered completely demand-related and only facilities such as meters, regulators and service taps are considered to be customer related. Ex. 11, p.4. Therefore, the ALJ finds that Interstate should not be ordered to conduct a minimum distribution study as part of its next rate case.

Conservation Improvement Program Expenses

187. The Company, in its direct testimony, allocated its Conservation Improvement Program (CIP) expenses to all customer classes. The Department agreed with this methodology because Interstate incurs cost effective CIP expenses to provide system benefits and lower rates for all ratepayers. Therefore, it is appropriate that all ratepayers should bear the costs of CIP. Ex. 23, p. 6.

188. The Company changed its position regarding the allocation of CIP expenses in rebuttal testimony, apparently in response to the testimony presented by intervenor ConAgra. In rebuttal testimony, Interstate witness Reisdorf testified that it is Interstate's position that transportation customers should be given a credit for CIP expenses. The rationale put forth by Mr. Reisdorf in support of this position is that the Company does not believe that transportation

customers can participate in the CIP program and, therefore, should not be required to pay its cost. Ex. 9, pp. 4, 8.

189. ConAgra intervened in this proceeding because of its mistaken belief that it is not eligible to participate in the CIP program as a transportation customer. Ex. 26, p. 2. Interstate, as noted above, has taken the position that transportation customers should not participate in CIP. Ex. 9, p. 8. In response to this position of the Company, ConAgra is requesting that no CIP costs be allocated to transportation customers if they are ineligible to participate in the CIP program. Ex. 26, p. 2.

190. The Commissioner of the Department of Public Service determines eligibility for CIP programs, not Interstate. The Commissioner has determined that transportation customers are eligible to participate in CIP programs. The Department has indicated that it will help any Interstate transportation customer, including ConAgra, who requests assistance to propose a CIP project if the Company is unwilling to provide assistance. Ex. 24, pp. 2-4. However, the issue of CIP eligibility cannot be determined in this rate case since the Commissioner of the Department, not the Public Utilities Commission, makes that determination. Minn. Stat. § 216B.241 (1994).

191. Interstate incurs cost effective CIP expenses to provide system benefits and lower rates for all ratepayers. Therefore, it is appropriate that all ratepayers should bear the costs of CIP regardless of their participation in the program. Furthermore, as stated above, the Department's policy is that all customers, including transportation customers, are eligible to participate in CIP, if projects meet qualifying criteria. Ex. 24, p. 3. For these reasons, the ALJ finds that the costs of CIP should be allocated to all customer classes.

<u>Pricing Structures for Sales and Transportation Customers</u>

192. The Department's recommendations concerning the pricing structure for the standard sales class was determined as follows: First, Department witness Chavez determined the total amount of revenue to be recovered from each customer class using the Department's CCOSS. He then decided on the most appropriate customer charges. Next, for each class, he determined the total revenues to be recovered through the customer charges. To determine the commodity charge, he subtracted the customer charge revenues from the total revenues to be collected from the class and divided the remaining revenues for each class by the projected test-year sales volume for that class. Ex. 37, pp. 8-9.

193. Transportation demand and commodity rates should be set to produce the same margins as are recovered from the standard sales customers. The Department recommended that the same customer charge be instituted for both transportation and sales classes with an additional administrative and delivery fee for transportation customers to reflect the higher administrative costs involved in serving those customers. This rate-design keeps the Company indifferent regarding whether the customer purchases gas through the transportation or sales service. Ex. 37, p. 9.

194. Since this Report includes a lower revenue requirement than Interstate has requested, the revenue requirement should be apportioned to the customer classes proportionately consistent with the Department's recommendation. The ALJ adopts the customer charges as recommended by the Department and recommends determination of the corresponding commodity rates as indicated above. Ex. 37, p. 10.

Apportionment of Revenue Responsibility

195. Department witness Chavez reviewed the Company's proposed criteria for apportioning its revenue requirement. The Company's apportionment was based upon its CCOSS. The Company proposed apportioning its revenue requirement using the following percentage increases by class:

Interstate's Recommended Revenue Apportionment

Class	Interstate's Proposed Apportionment	Cost-based Apportionment	Percent Increase From Present Revenue
General Service (Rate 511)	92.58%	92.89%	31.66%
Interruptible Sales (Rates 524 and 526)	5.18%	5.61%	5.87%
Interruptible Transportation (Rates 525 and 527)	1.92%	1.49%	20.25%

Ex. 37, pp. 10-11.

196. Department witness Chavez developed the Department's proposed revenue apportionment based upon the Department's CCOSS and its rate design goals. The Department's objective for revenue apportionment is to promote an efficient use of resources while attempting to moderate and fairly distribute responsibility for the large rate increase proposed by Interstate.

197. While cost causation is an important consideration when designing rates to promote an efficient use of resources, other rate design goals must be considered as well. Another very important consideration is the price of competitive fuels for the interruptible classes, which have the potential to switch from natural gas to alternative fuels. Rates for the interruptible classes should be designed to be competitive with alternative fuels. Ex. 37, pp. 12, 15.

198. Based upon the Department's revenue apportionment criteria, and using Interstate's proposed revenue request, the Department proposed the following percentage increases by class:

Department-Recommended Revenue Apportionment

Department Class	Proposed Revenue Apportionment	Percent Increase From Cost-based Apportionment	Present
General Service			
Firm Sales Service (Rate 511)	90.46%	92.89%	28.65%
Firm Transportation Service (Rate 512)	0.00%	0.00%	0.00%
Other Revenue	0.32%	0.00%	50.02%
Subtotal	90.78%	92.89%	28.72%
Small Volume Interruptible			
Small Volume Interruptible Sales (Rate 524)	4.58%	4.42%	20.60%
Small Volume Interruptible Transportation (Rate 512)	2.65%	1.05%	100.17%
Subtotal	7.23%	5.47%	41.19%
Large Volume Interruptible			
Large Volume Interruptible Transportation	1.33%	1.19%	18.55%
(Rate 527) NON-FLEX	0.66%	0.44%	141.17%
Large Volume Interruptible Transportation (Rate 527) - FLEX)	0.00%	0.00%	0.00%
Subtotal	1.99%	1.63%	42.57%

Ex. 37, p. 13.

199. The Department's recommended revenue apportionment results in an increase of 28.72 percent for the General Sales Service (Rate 511) customer class compared to Interstate's proposed increase of 31.73 percent. Its recommended revenue apportionment results in increases of 41.19 percent for the Small-Volume Interruptible customer classes and 42.57 percent for the Large-Volume Interruptible customer classes. Ex. 37 at (VCC-3). This is compared to Interstate's proposed increases of 6.82 percent for the Small-Volume Interruptible customer classes and 16.39 percent for the Large-Volume Interruptible customer classes. Ex. 37, p. 14.

200. Interstate witness Reisdorf objected to the Department's proposed revenue apportionment for interruptible customers claiming that it could potentially harm the Company if interruptible customers leave the system for an alternative fuel source. Ex. 9, pp. 5-6.

201. While the Department's proposed revenue apportionment for interruptible customers is larger than that proposed by Interstate, there are several reasons why it is unlikely that interruptible customers will leave Interstate's system based on this higher revenue apportionment. First, Interstate's interruptible service tariffs require that interruptible customers have the ability to shut down or switch to an alternative fuel when curtailed. Only those interruptible customers with the proven ability to switch to an alternative fuel have the potential to switch ultimately when the price of competitive fuel warrants. Interstate is not at risk of losing its other interruptible customers. Ex. 37, p. 14.

202. Second, and most importantly, the rates that result from the Department's recommendation are below the prices of competing alternative fuels. Mr. Chavez examined the price of the two primary alternative fuels, Number 2 fuel oil and propane. Using Interstate's initially filed revenue deficiency and the base-cost-of-gas approved in Docket No. G001/M-95-413, the Department's proposed revenue apportionment results in a natural gas rate for Small-Volume Interruptible (SVI) customers of $2.87 per Mcf. This translates to approximately $2.87 per MMBtu. In contrast, the average 1994 spot price of Number 2 fuel oil delivered to Rochester, Minnesota, was $3.91 per MMBtu, and the average 1994 retail residential propane price was $8.02 per MMBtu. Thus, the Department's proposed rates, while higher than Interstate's, are still substantially lower than alternative fuel prices. Ex. 38, p. 2.

203. Examining the price difference over a longer period demonstrates the same relative price differences. For example, between July 1993 through August 1995, the spot price of Number 2 fuel oil has been consistently higher than the adjusted Interstate total SVI rate by approximately 37 percent. The retail price of propane sold to commercial customers has been consistently higher than the total SVI rate by approximately 66 percent. See, Ex. 38 at (VCC-1). The increase proposed by the Department would change the percentage difference between SVI rates and Number 2 fuel oil prices to approximately 27 percent.

204. The Department's recommended rates do not harm the company and do not "overcharge" interruptible customers. They do result in more competitive natural gas rates for Interstate's interruptible customers than the rates proposed by Interstate and they are lower than the alternative fuel prices. Ex. 38, pp. 2-3. In contrast, the Company's proposed revenue apportionment for interruptible customers does not reflect the economic value of the commodity to the customer because it does not reflect the cost of alternative fuels. Tr. Vol. 1 at 211.

205. IPW witness Reisdorf testified that Number 2 Fuel Oil may fluctuate violently in response to supply and demand over that same period. IPW proposed to establish its price at cost, fearing that the Department proposal places more IPW revenue at risk in the less stable environment of competitive fuels. IPW argued that if the alternate fuel price drops, IPW earnings will be negatively impacted as IPW will not only lose the cost of service for the interruptible rate but also that share of the firm class the Department added to the interruptible class for recovery. Ex. 9, pp. 5-6 However, alternative fuel prices have not drastically fluctuated in recent years. While there are variances in the prices of competitive fuels, the related difference between prices of natural gas and competitive fuels has fluctuated only modestly. Ex. 38, pp. 2-3.

206. A comparison of the difference between Interstate's interruptible rates and the price of Number 2 fuel oil, the most price competitive alternative fuel, with SVI rates demonstrates this point. From July 1993 through August 1995, the SVI rate was $2.4833 per MMBtu adjusted to include only appropriate purchased gas adjustment components. During the same period, the average spot price of Number 2 fuel oil was $3.9463 per MMBtu. The average difference between SVI rates and Number 2 fuel oil was $1.4630 per MMBtu with a minimum difference of $0.4738 per MMBtu and a maximum difference of $2.1657 per MMBtu. Ex. 38 at (VCC-1). While the price of competitive fuels do fluctuate, the average spot price of Number 2 fuel oil is constantly higher than Interstate's billed SVI rate and the relative difference remains fairly constant. Id. pp. 3-4.

207. Moreover, a dramatic drop in alternative fuel prices would be contrary to recent trends. Only when the delivered price of Number 2 fuel oil or propane would fall below the interruptible rate would those interruptible customers with the ability to switch to an alternative consider leaving Interstate's system. As shown graphically in Ex. 38 at (VCC-2) and (VCC-3), the prices of the alternative fuels have not dropped below Interstate's interruptible rates in at least the last two years. Id.

208. In addition to analyzing the spot prices of Number 2 fuel oil delivered to Rochester, Minnesota, to develop his recommendation, Mr. Chavez also examined the average retail price of Number 2 fuel oil sold to Minnesota commercial customers. As illustrated in Ex. 38 at (VCC-4), a comparison of the average retail Minnesota price of Number 2 fuel oil to Interstate's interruptible rates confirms that the price of Number 2 fuel oil has not dropped below Interstate's interruptible rates since the implementation of final rates in the Company's last rate case (Docket No. G001/GR-90-700) in September, 1991. Even with the increase recommended in this case, Interstate's interruptible rates would still have been competitive over this period. Id., p. 5.

209. Since the Department's proposed rates are competitive with alternative fuels, it is unlikely that Interstate will need to use its flexible-rate tariffs with its interruptible customers. However, in the unlikely event Interstate is faced with the loss of customers because of price competition from alternative fuels or bypass as a result of a rate increase from the instant rate case, the Company can retain its customers using flexible-rate tariff provisions. Id., pp. 14-15.

210. IPW argued that apportioning revenue in excess of cost to the interruptible group with the expectation that sales can be saved by flexing adds risk to IPW earnings and its ability to recover its revenue requirement. IPW witness Reisdorf testified that an additional risk to IPW is that in flexing rates to save interruptible sales, IPW will not recover not only the firm class costs the DPS has moved to the interruptible class (by using value of service to set IPW's interruptible rates) but, also, the actual costs to serve the interruptible class itself. Ex. 9, p. 6. However, the use of flexible rates could potentially result in Interstate recovering more than its costs. Flexible-rate customers must remain under the flexible tariff for one year. While the minimum rate recovers only incremental costs, the maximum rate can be as high above the standard rate as the minimum rate is below the standard rate. Thus, if the monthly rate is above the standard rate, the Company will recover more than its costs and increase its earnings. Therefore, Interstate could potentially benefit from the use of flexible rates. Ex. 38, p. 6. In the unlikely event Interstate's flexible tariff must be utilized, the Company and ratepayers will be at equal risk under Interstate's flexible tariff.

211. The Company's proposed revenue apportionment results in a decrease in customer bills for interruptible customers even though such a decrease in customer bills is not

needed to remain competitive with alternative fuels available to interruptible customers. Given the magnitude of the increase in firm customers' bills that result from the Company's proposed revenue requirements, it is more appropriate to spread the increase more evenly among all customer classes. In particular, the need to establish the lowest reasonable rates for low-income residential customers is contrary to Interstate's proposal which would disproportionately shift revenue requirements to them.

212. Interstate cites the case of Re: Interstate Power Company, MPUC Docket No. E-001/M-94-384, Order Rejecting Proposed Bulk Supply Rate, dated August 3, 1994. In that case, IPW filed a proposal to offer a Bulk Supply rate to qualifying Large Power and Light customers. DPS filed comments recommending rejecting the proposal on grounds that the rate components did not adequately reflect the components of the cost of service, undermining the central rate design principle that both rates and their component parts should closely reflect the cost of service. The Commission rejected the proposed rate because its components did not reflect costs accurately enough for a standard rate. The MPUC agreed. The MPUC made a similar finding in Re U S West Communications, MPUC Docket No. P-421/M-88-968, Docket No. P-421/EM-93-691, Docket No. P-999/M-92-1268, Order dated August 11, 1993, stating the Company's proposed rates would better reflect the actual cost of service and would ensure a closer tie between the rates charged for specific services and the costs of providing those services. Finally, IPW argues that the DPS position is inconsistent with the MPUC's decision in Interstate Power Company, MPUC Docket No. G-001/N-95-157 and the DPS position in that case that interruptible customers are very price sensitive and that lower gas costs should be allocated to that class. Tr. 203-205.

213. A substantial variance between revenue and costs is appropriate in this case. The Department's recommendation regarding revenue apportionment results in an increase in customer bills for all customers while keeping Small and Large-Volume Interruptible customers' rates competitive with the costs of alternative fuels. By apportioning more revenue responsibility to the interruptible classes, the Department's recommendation moderates and more fairly distributes responsibility for the large rate increase proposed by Interstate. Ex. 37, p. 15; Ex. 38, p. 7. Based upon the foregoing, the ALJ adopts the Department's recommended revenue apportionment in this proceeding.

Customer Charges

214. Customer charges should reflect the cost of providing service to customers regardless of system use, and that the Company should have the opportunity to recover such costs. To the extent possible, customer charges should have historical continuity and move toward costs gradually to minimize drastic rate impacts. Ex. 37, p. 16.

215. IPW and the DPS disagree regarding basic service charge or customer service charges. IPW believes that its proposals move these charges closer to cost which IPW believes is the MPUC's goal. Ex. 9, p. 6. It also believes its approach reduces the Company's risks compared to the DPS's proposals because if customer charges are held below cost, recovery of those fixed costs by Interstate is dependent upon volumes.

216. Department witness Chavez reviewed the Company's proposed customer charges for all of its rate classes. Using the Department's CCOSS, he examined the Company's proposal to determine if they were cost based. The results of Mr. Chavez' investigation are as follows:

Interstate's Proposed Customer Charges

Proposed Class	Present Customer Charge	Interstate's Proposed Customer Charge	Proposed Percent Difference	Cost-Based Customer Charge	Percent Charge of Cost
Firm Sales Service (Rate 511)	$4.75	$7.00	47.37%	$19.39	36.10%
Small Volume Interruptible Sales (Rate 524)	$14.00	$25.00	78.57%	$105.88	23.61%
Small Volume Interruptible Transportation (Rate 525)	$100.00	$150.00	50.00%	$158.13	94.86%
Large Volume Interruptible Sales (Rate 526)	$185.00	$275.00	48.65%	$172.15	159.74%
Large Volume Interruptible Transportation (Rate 527)	$100.00	$150.00	50.00%	$1,286.87	11.66%

Ex. 37, pp. 15-16.

217. Interstate's proposed customer charges send mixed price signals. For example, while it appears that the Company is attempting to move closer to cost-based customer charges in general, the proposed customer charge for Large-Volume Interruptible Sales (Rate 526) customers is substantially above cost, and the proposed customer charge for Large-Volume Interruptible Transportation (Rate 527) customers is substantially below cost. The Department's proposed customer charges correct these flaws by moving the customer charge to Large-Volume Interruptible Sales customers close to cost without imposing a charge above cost, while increasing the customer charge for Large-Volume Interruptible Transportation customers to move it closer to cost. Ex. 37, pp. 18-19.

218. The Department determined its proposed customer charges by reviewing the Department's CCOSS which provides the specific customer cost for each customer class. Department witness Chavez identified the average cost imposed by each of Interstate's customer classes under the Department sponsored CCOSS. Using these figures and the Commission-approved customer charges for other regulated Minnesota gas utilities, the Department proposed customer charges as follows:

Department's Proposed Customer Charges

Class	Present Customer Charge	DPS's Proposed Customer Charge	Proposed Percent Difference	Cost-Based Customer Charge	Percent Proposed Charge of Cost
Firm Sales Service (Rate 511)	$4.75	$6.00	26.32%	$19.39	30.94%
Small Volume Interruptible Sales (Rate 524)	$14.00	$25.00	78.57%	$105.88	23.61%
Small Volume Interruptible Transportation (Rate 525)*	$100.00	$150.00	50.00%	$158.13	94.86%
Large Volume Interruptible Sales (Rate 526)	$185.00	$170.00	-8.11%	$172.15	98.75%
Large Volume Interruptible Transportation (Rate 527)*	$100.00	$295.00	195.00%	$1,286.87	22.92%

* NOTE:The Department's proposed monthly charges to transportation customers include the same customer charge as the equivalent sales class and an "administrative and delivery" fee of $125 for the additional cost of serving gas transportation customers.

Ex. 37, pp. 16-17.

219. As shown in the above chart, the Department's proposed transportation customer charges are identical to the customer charges of the equivalent sales classes with a higher fee to cover the additional cost of serving transportation customers. For example, the Department proposes that the customer charge for Small-Volume Interruptible Sales customers and Small-Volume Interruptible Transportation customers each be $25.00. Transportation customers would pay an additional administrative and delivery fee of $125.00 for a total charge of $150.00. The administrative and delivery fee is necessary to recover the higher administrative cost involved in serving transportation customers. The only price differences sales and transportation customers will experience is the cost of gas and the administrative and delivery fee necessitated by the higher cost of serving transportation customers. Ex. 37, pp. 17-19; Ex. 38, 8-9. Interstate witness Reisdorf concurred in the Department's recommendation that customer charges for transportation customers should mirror those of sales customers with the addition of an administrative and delivery charge. Tr. Vol. 1 at 55.

220. IPW's proposed basic service charges recovers 36% of costs for General service customers; 23% for Small Volume interruptible customers and 38% for Large Volume interruptible customers. IPW witness Reisdorf testified that unless completely separate rates are developed for transportation and sales customers within a class, segregating customer costs into sales and transportation is inappropriate and would be confusing to customers who, at this point, see that the only difference between being a sales customer or being a transport customer boils down to gas cost only differences. Ex. 9, p. 7.

221. Most interruptible customers will experience little, if any, impact in their annual bills due to the customer charge increase alone, because the higher customer charges are offset, to some degree, by relatively lower commodity charges. Thus, at higher levels of use, customers may even experience overall lower bills than they would under the present customer charges due to the shift in revenue recovery from the commodity charge to the customer charge. Ex. 37, pp. 20-21.

222. The Department proposed a customer charge of $6.00 for General Sales Service customers (Rate 511) while the Company's proposed a $7.00 charge. General Sales Service customers who use 10 Ccf per month would experience an increase of $2.09 per month, an approximately 21 percent increase, under Interstate's proposed $7.00 customer charge. Ex. 37 at (VCC-7). The same customers using 10 Ccf per month would experience an increase of $1.16 per month or approximately 12 percent under the Department's proposed $6.00 customer charge. Ex. 37 at (VCC-8); Ex. 37, p. 20.

223. The Department argued that its recommended $6.00 customer charge for General Sales Service customers (Rate 511) gradually moves this rate closer to cost and is consistent with the customer charges approved by the Commission for firm residential customers in recent decisions in Docket Nos. G002/GR-92-1186 (Northern States Power Company's most recent rate case) and G011/GR-92-132 (Peoples Natural Gas Company's most recent rate case). Ex. 38, p. 8.

224. Under both the Department's and Interstate's customer charge proposals, customers who use little gas and currently do not pay for the customer costs allocated to them, would pay higher bills than with current customer charges, while those customers who use more gas would pay lower monthly bills. Under both proposals, General Sales Service customers who use about 144 Ccfs per month would see little or no change in their bills due only to the change in customer charges. Ex. No. 37 at (VCC-7) and (VCC-8); Ex. 37, pp. 19-20.

225. As IPW argues, the case of <u>Re: Interstate Power Company</u>, MPUC Docket No. E-001/M-94-384, Order Rejecting Proposed Bulk Supply Rate, dated August 3, 1994, discussed in the interruptible rates section, is equally applicable to this issue. But again, exact correspondence of revenue to cost is not required. Overall, the Department's proposed customer charges move the charges closer to cost than do the Company's, while avoiding large changes to prevent extreme rate impacts on customers. For these reasons, the ALJ adopts the Department's recommended customer charges.

<u>Additional Rate-Design And Condition Of Service</u>

226. The Department recommended that the Commission require the following rate-design changes in Interstate's next rate case:

a) The Company should establish separate firm customer classes broken into residential, commercial and industrial. The Company should propose rates which reflect the cost differences in written testimony at the time of their next rate case.

b) The Company should provide further information distinguishing Small-Volume and Large-Volume Interruptible Sales and Transportation customer classes and present a CCOSS which first provides a breakout of the costs to serve each type of interruptible sales and transportation customer based on consumption levels; and second, provides a breakout of the cost to serve each type of interruptible sales and transportation customer based on curtailment priorities.

Ex. 37, pp. 30-31.

227. The Company accepted these Department recommendations except that it did not agree to break firm customer classes into three categories: 1) residential, 2) commercial, and 3) industrial, as recommended by the Department. It proposed to break firm customer classes into two categories: 1) residential and 2) commercial and industrial. This was clarified in the cross-examination testimony of Interstate witness Reisdorf. The Company indicated its willingness to present these recommended proposals in its next rate case if the proposals may be based on reasonable class estimates. Ex. 9, pp. 7-8; Tr. Vol. 1, pp. 50-53. The Department accepted, as a reasonable first step, the Company's request to break firm customers into two categories instead of three.

228. The ALJ adopts the Department's recommendations listed above, as modified by the Company, because the information will provide a more accurate picture of which customers are responsible for which costs in Interstate's next rate case.

229. The Department further recommended that the Company should include a flexible rate provision in all of its current sales and transportation tariffs in compliance with the final decision in this rate case. The Company did not object to this proposal. Ex. 9, p. 8. The ALJ adopts this proposal.

230. Interstate proposed to raise the customer reconnection charge from the present cost of not less than $5.00 to a standard average fee of $35.00. The proposed reconnection charge is based on the current, actual cost involved in reinstating service. Using one average rate is more administratively efficient than using a non-uniform rate. For these reasons, the Department accepted Interstate's proposal to raise the customer reconnection charge to $35.00. The ALJ adopts this recommendation.

<u>INTERSTATE'S EXPANSION TO NEW TOWNS</u>

231. MPUC's June 23, 1995 Order setting this case for hearing instructed the parties to address the two issues of whether IPW's expansion to new towns was economically justified and in compliance with IPW's service extension policy.

232. The MPUC's March 31, 1995 "Order Terminating Investigation and Closing Docket" in Docket No. G-999/CI-90-563 relates to these issues. That docket concerned an MPUC investigation into competition between gas local distribution companies ("LDCs") in Minnesota. In particular, the MPUC's March 31, 1995 "Order Terminating Investigation and Closing Docket" in Docket No. G-999/CI-90-563 specifically stated that certain issues related to service extension policies should be addressed in future rate cases. In that docket, the Commission asked the Department to investigate the Company's service extension related additions to rate base to ensure the following: 1) that LDCs are applying their extension policy tariffs correctly and consistently; 2) that the extensions are appropriately cost and load justified; and 3) that wasteful additions to plant and facilities are not allowed into rate base. Ex. 37, pp. 27-28.

233. IPW witness Richards described IPW's service extension policies which are contained in Original Volume No. 6, Sheet Nos. 6 through 12 of IPW's Minnesota gas tariffs.

These tariffs were attached to Ex. 5 (Schedule No. 1) for reference. Mr. Richards testified that these tariffs have the following components:

a) Customer cannot elect to use an independent contractor.

b) IPW will provide up to 75 feet free of charge for firm gas service.

c) Customer will pay any additional expense due to abnormal obstruction or soil condition on customer's premises.

d) IPW will supply 125 feet of main extensions for each residential applicant when such extension is necessary to serve an applicant or group of applicants.

e) Main extensions that are greater than 125 feet require a service agreement for 5 years and a monthly main extension charge.

f) Main extensions to new subdivisions will be provided as long as developer makes a deposit equal to construction costs. Such a deposit may be refunded depending upon the number of new services connected.

g) Main extensions to general service customers are the same as for residential customer. However, if the customer executes a 5 year agreement, IPW will make a main extension if the minimum annual billing is 1.2x the cost of the main and service extension.

h) Main extensions to interruptible customers require a 5 year agreement, IPW will make a main extension if the minimum annual billing is 1.5x the cost of the main and service extension. Ex. 5, pp. 4-5.

234. The DPS investigated Interstate's service extension policies as directed by the Commission. The DPS's investigation focused on additions to rate base that are the result of service extensions to six towns which have been piped since Interstate's last rate case. The DPS used an "economic feasibility" model similar to that recently approved by the Commission for Northern State's Power and confirmed that the Company's cost to the six extension projects are covered by the expected revenue from the additional customers. Since the six towns were not previously served by any other regulated natural gas utility, and because the extensions are cost and load justified, the DPS did not challenge the additions to rate base that are the result of the expansion to the six towns since the last rate case. The DPS further investigated whether IPW is applying its service extension tariff correctly and consistently and determined from the evidence available that it is. Ex. 37, pp. 28-30; Tr. 212.

235. The ALJ concludes that the Interstate is applying its extension policy tariffs correctly and consistently, and that the extensions to the six towns are appropriately cost and load justified and should be allowed into rate base. Neither the DPS nor the OAG advocated any adjustment to IPW's rate increase request related to IPW's expansion to serve new towns. The DPS performed studies regarding the economics of these expansion projects. Exs. 37 (pp. 27-30); DPS Exhibit (VCC-11) attached to Ex. 37; 43 and Tr. 211-213. IPW's expansion to new towns was economically justified and in compliance with IPW's service extension policy and in conformance with the Board's policies.

EFFECT OF RATE INCREASE ON LOW-INCOME CUSTOMERS

236. The ALJ asked the parties to discuss the Commission's position regarding rate increases to low income customers who have difficulty paying their utility bills at current rates. The DPS has informed the ALJ that the Commission addressed this issue in NSP's 1993 Rate Case Order (Docket No. E-002/GR-92-1185). In that case, the Commission directed the parties to discuss the possibility of establishing a low-income rate and special medical needs discount. The OAG proposed a specific program to meet the needs of low income and special medical needs customers in response to the directive. The Commission rejected the proposal and determined that the problem should be resolved by the legislature to ensure the consistent treatment of low-income ratepayers and the general body of ratepayers on a statewide basis. NSP 1993 Rate Case Order, pp. 91-94.

237. The legislature addressed the issue of low-income ratepayers in Minn. Stat. § 216B.16, subd. 15 (1994). That statute provides that the Commission may consider ability to pay as a factor in setting utility rates and may establish programs for low-income residential ratepayers. It also requires the commission to order a pilot program for at least one utility. The Commission has established a pilot low-income rate program using Minnegasco as the utility conducting the pilot. The pilot, scheduled to continue until June 30, 1998, will consider a number of issues such as the effects of low-income rates on non-participating customers. Thus, the effects of low-income rates are not known at this time.

238. The present rate case is the first one to be filed under the new legislation. Therefore, the Commission has not yet determined whether it will consider ability to pay as a factor in setting rates. No party to this proceeding has advocated that the Commission adopt a separate rate for low-income customers in this case.

239. The Department's position is that the Commission should keep rates as low as possible for all customers within the dictates of the law and that the Department's proposals will help accomplish that objective. Likewise, the OAG has not proposed that IPW adopt a separate low-income rate in this proceeding, but does recommend that the Commission consider the effect of the proposed rate increase on customer's ability to pay in determining IPW's final rates. The OAG also argued that this factor mitigates in favor of establishing the lowest rates possible while still providing Intestate shareholders with a reasonable rate of return.

240. The size of the rate increase in this case means that there will be an enormous impact upon low income ratepayers. For example, retired minister Gilbert J. Kuyper of Albert Lea would find his monthly budget rate payment of $106 go to $132 under Interstate's original proposal; clearly a hardship on a minister's pension. Public Ex. 12. The ALJ is disappointed that the DPS and OAG have not suggested using the new statute. But application of the statute requires data and argument that is not available in this record. Thus, the ALJ concurs that that the only solution for now is that the rates should be kept as low as possible for all customers within the dictates of the law.

REVENUE DEFICIENCY

241. As a result of the rate of return, rate base and operating revenues and expenses adopted in this Report, Interstate's revenue deficiency must be adjusted, as must Appendix A (Ex. 44), attached hereto, which provides the complete revenue requirement impact of each recommendation.

Based upon the foregoing Findings of Fact, the Administrative Law Judge makes the following:

CONCLUSIONS

1. The Minnesota Public Utilities Commission and the Administrative Law Judge have jurisdiction in this matter pursuant o Minn. Stat. Ch. 216B, Minn. Stat. §§ 14.57-14.62, and Minn. R. 1400.5100-.8300.

2. Any of the foregoing Findings of Fact more appropriately considered Conclusions are adopted as such.

3. The Company's proposed test year of January 1, 1994, to December 31, 1994, is reasonable.

4. Interstate's proposed capital structure, cost of debt and cost of preferred stock should be adopted.

5. Mr. Jackson's DCFQB method is flawed because it completely ignores the actual market for the stock of the comparison companies.

6. The payout ratio study used by Mr. Jackson is unreliable.

7. Mr. Jackson's regression model is overly simplistic and results in biased estimates. It is incomplete and fails to take into account the effect of other important variables that might affect the allowed ROE awarded by state commissions.

8. MUI's proposed ROE is not based on a method of calculating ROE that has been shown to be analytically sound or has been accepted by the Commission.

9. The appropriate method for calculating a fair ROE is the DCF method. It produces consistent, reliable results and has been consistently used by the Commission.

10. A 6.25 percent dividend yield and 4.50 percent estimated growth rate are appropriate for the purpose of deriving the estimated ROE in this case. Combining the 6.25 percent dividend yield with a growth factor of 4.50 percent produces an ROE of 10.75 percent, which is an appropriate ROE that fairly balances the requirements of shareholders and the interests of ratepayers.

11. The appropriate required overall rate of return for Interstate is 8.817 percent based upon the return on equity of 10.75 percent, as well as the Company's proposed costs of long and short-term debt and preferred stock and capital structure. This will enable Interstate to maintain its financial integrity while resulting in just and reasonable rates for ratepayers and should be adopted for this case.

12. Interstate’s proposed estimated rate case expenses of $160,958 should be approved.

13. Intestate’s past history in filing frequency is appropriate basis for determining the appropriate amortization period for the rate case expenses. Interstate has shown no reason to that rate case expenses will likely increase because of manufactured gas plant cleanup

expense increases or CIP expense increases. Based upon history and using Interstate's estimate of total rate case expenses, Interstate's proposed rate case expenses should be reduced by $21,553 to $32,100. Ex. 44, (Stp. 37), column (f).

14. Interstate has not met its burden of proof to show that it will lose any time value of money or that for any other reason a rate base addition is appropriate. Therefore, Interstate's proposed test year rate case expense should be reduced by $21,553 to reflect an average annual expense of $32,100 and rate base should be reduced by $134,132 to remove any hypothetical "unamortized balance" of rate case expenses from rate base.

15. December 31, 1994 plant balances rather than Interstate's proposed thirteen-month average test-year plant balances should be used so as to be consistent with the use of December 31, 1994 customer counts. Implementation of this adjustment increases net utility plant and thus, rate base by $199,738, (Ex. 44 (STP-4), column 1) and should also be made.

16. Acceptance of the Department's proposal for recovery of the Conservation Improvement Program (CIP) tracker balance requires a reduction to rate base of $250,809. Ex. 44 (STP-34), col. 2.

17. Adjustments to rate base and operating expense affect the calculation of the lead/lag study and thus necessitate a recalculation of the cash working capital amount resulting in a reduction in rate base of $25,413. Ex. 44 (STP-34), col. 4.

18. Interstate’s deferred expenditure of $4,940,173 for cleanup expenses associated with former manufactured gas plants located in Rochester and Albert Lea is a necessary and reasonable expense.

19. The argument that the provision of manufactured gas is a different utility from the provision of natural gas must be rejected because it is contrary to Commission precedent and the common sense upon which the Commission precedent is based. Manufactured gas and natural gas are much alike; they are both combustible, gaseous substances distributed to customers through piping and used by the customers for heat and light.

20. The production and distribution of manufactured gas constitutes utility service. The Commission has not distinguished between manufactured and natural gas previously and no basis exists to do so now. Both the Albert Lea and Rochester sites were used and useful in the provision of gas utility service at the time of pollution and, therefore, recovery of these expenses is appropriate.

21. There is no significant factual distinction between the NSP case regarding Faribault, NSP, Docket No. G-002/GR-85-108, and the facts of Interstate's MGP site at Albert Lea. The Commission found the Faribault site to be used and useful not because the plant produced natural gas and served natural gas ratepayers, but because the site had been used in the normal provision of utility service at the time of pollution. The Albert Lea site is used and useful for the same reason.

22. Recovery of the MGP cleanup expenses in Rochester is appropriate. The lack of current Interstate customers in Rochester is not a basis for denial. The lack of customers is not inconsistent with previous decisions or general ratemaking principles. Recovery is

consistent with the Commission's policy to allow recovery for prudent, reasonable, MPCA mandated environmental remediation expenses.

23. The statements regarding the possibility of no recovery made to shareholders and the Board of Directors are not binding admissions by the Company that the deferred MGP expenses should not be recovered in the rates. Their only real significance in this proceeding are that they make it clear that the Company and its shareholders are well aware that they may have to bear some or all of the cost of the remediation.

24. The fact that Interstate wrote off the MGP costs from 1991 through 1993 does not constitute an admission of their nonrecoverability, nor does it violate any Commission enforced accounting rule or procedure which would justify disallowal of the costs.

25. Interstate's shareholders benefit equally from the MGP cleanup. Therefore, Interstate should be allowed to recover only 50 percent of the deferred MGP cleanup expense of $4,940,173.

26. Denying carrying costs is too loose an approximation and it is more appropriate to divide the expense by two and amortize it over an appropriate period with a carrying charge. A carrying charge of eight percent is appropriate at this point in time, as is an amortization period of 15 years. That results in annual installments of $288,579. That is an appropriate amount.

27. Interstate's requested $60,610 in PBOP expenses to reflect the adoption of FAS 106 accrual accounting, requested amortization of deferred PBOP costs over three years resulting in a test-year expense of $73,258, and proposal to externally fund its PBOP obligation through a Voluntary Employee Benefit Association (VEBA) for union employees so that all contributions will be fully tax deductible in a 401(h) account are reasonable and appropriate.

28. Interstate's test-year compensation expenses, including its nonpension post retirement benefits are reasonable and should be allowed in rates.

29. The DPS's allocation of a portion of the main common administrative and general cost categories of officers and general office salaries and expenses and employee benefits to the nonregulated operation using a general allocator should be adopted by reducing test year A&G expenses by $1,397.

30. Interstate's economic development costs should be allowed at the rate of 50 percent. Thus, $4,415 should be disallowed from IPW's proposed expenses.

31. Interstate should be required in its next rate case to provide a more detailed specification of its Minnesota economic development activities and results so that the benefits can more easily be determined.

32. Interstate's 1994 actual property tax amount should be used for the 1994 test-year, decreasing the proposed Property Tax expense by $8,797.

33. The Department's calculation of revenues included in Exhibit 44, Sched. C-1, pp. 1-2 should be used for calculating rates in this proceeding.

34. Test year rate case expenses should be reduced by $21,553. Ex. 44 (STP 37), column (f).

35. The Department approved CIP tracker amount of $596,389 should be included in rates unless the Commission approves a modification; in which case, the modified amount should be allowed.

36. The CIP tracker balance should be expensed over five years and Interstate's inclusion of half of the tracker balance in rate base should be denied. Interstate should be required to track its unrecovered balance and the balance should accrue carrying charges in the same manner as the current CIP tracker. As a result, Interstate's proposed rate base should be reduced by $250,809. Ex. 31, (SLB-4); Ex. 44, (STP-34), col. 2.

37. Test-year CIP expense of $254,125 is reasonable and should be included in test-year expenses.

38. Calculation of the CCRC should be made by dividing the approved test-year CIP expenses by the approved total test-year sales, including transportation. Ex. 33, pp. 10-11.

39. Since separately allocating costs to transportation customers provides a more accurate picture of cost causation, the Department's CCOSS which provides this allocation should be adopted.

40. The Department has presented no evidence that a minimum distribution study of the type it suggests would improve the cost allocation methodology used by the Company or have any practical benefit. Therefore, Interstate should not be ordered to conduct a minimum distribution study as part of its next rate case.

41. The Commissioner of the Department of Public Service determines eligibility for CIP programs and has determined that transportation customers are eligible to participate in CIP programs. The issue of CIP eligibility cannot be determined in this rate case since the Commissioner of the Department, not the Public Utilities Commission, makes that determination. Minn. Stat. § 216B.241 (1994).

42. All ratepayers, including transportation customers, should bear the costs of CIP regardless of their participation in the program. Therefore, the costs of CIP should be allocated to all customer classes.

43. Customer charges and determination of the corresponding commodity rates as recommended by the Department should be adopted.

44. While the Department's proposed revenue apportionment for interruptible customers is larger than that proposed by Interstate, it is unlikely that interruptible customers will leave Interstate's system because of the higher revenue apportionment.

45. The Department's recommended rates do not harm the company, do not "overcharge" interruptible customers, result in more competitive natural gas rates for Interstate's interruptible customers than the rates proposed by Interstate, and are lower than the alternative fuel prices.

46. The Department's recommended revenue apportionment should be adopted in this proceeding.

47. The Department's proposed customer charges move the charges closer to cost than do the Company's, while avoiding large changes to prevent extreme rate impacts on customers. For these reasons, the Department's recommended customer charges should be adopted.

48. The following rate-design changes should be required in Interstate's next rate case:

> a) The Company should establish separate firm customer classes broken into 1) residential and 2) commercial and industrial, based on reasonable class estimates. The Company should propose rates which reflect the cost differences in written testimony at the time of their next rate case.
>
> b) The Company should provide further information distinguishing Small-Volume and Large-Volume Interruptible Sales and Transportation customer classes and present a CCOSS which first provides a breakout of the costs to serve each type of interruptible sales and transportation customer based on consumption levels; and second, provides a breakout of the cost to serve each type of interruptible sales and transportation customer based on curtailment priorities.

49. The Company should include a flexible rate provision in all of its current sales and transportation tariffs in compliance with the final decision in this rate case.

50. Interstate’s proposal to raise the customer reconnection charge from the present cost of not less than $5.00 to a standard average fee of $35.00 should be adopted.

51. Interstate is applying its extension policy tariffs correctly and consistently, and the extensions to new towns are appropriately cost and load justified and should be allowed in rate base.

THIS REPORT IS NOT AN ORDER AND NO AUTHORITY IS GRANTED HEREIN. THE PUBLIC UTILITIES COMMISSION WILL ISSUE THE ORDER OF AUTHORITY WHICH MAY ADOPT OR DIFFER FROM THE FOLLOWING RECOMMENDATIONS.

It is the recommendation of the Administrative Law Judge that the Minnesota Public Utilities Commission issue the following:

ORDER

1. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and serve on all parties in this proceeding, revised schedules of rates and charges reflecting the revenue requirement for annual periods beginning June 30, 1995, and the rate design decisions contained herein. The Company shall include proposed customer notices explaining the final rates. Parties shall have 14 days to comment.

2. Within 30 days of the service date of this Order, the Company shall file with the Commission for its review and approval, and service upon all parties in this proceeding, a

proposed plan for refunding to all customers, with interest, any revenue collected during the Interim Rate period in excess of the amount authorized herein. Parties shall have 14 days to comment.

Dated this 16th day of January, 1995.

STEVE M. MIHALCHICK
Administrative Law Judge

NOTICE

Pursuant to Minn. Stat. § 14.62, subd. 1, the agency is required to serve its final decision upon each party and the Administrative Law Judge by first class mail.

[1]The forecasts published by IBES are provided by many of the largest institutional investment firms and by over 100 brokerage firms. Ex. 20, p.16.